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UNITED STATES TAX COURT

CANNONSBURG SKIING CORPORATION, (FORMERLY BROWN-SCHAEFER CORPORATION), TRANSFEREE OF THE ASSETS OF CANNONSBURG SKIING CORPORATION, TRANSFEROR, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

WALTER J. RUSSELL and MARY ANN RUSSELL, Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 5210-83, 5211-83[1]. Filed April 16, 1986.

Brown-Schaefer acquired 98 percent of Old Cannonsburg by purchase and 2 percent in a stock-for-stock exchange. Old Cannonsburg subsequently merged into Brown-Schaefer, which changed its name to New Cannonsburg. The merger qualified as a section 332 liquidation to which section 334(b)(2) applied.

Held: Old Cannonsburg's merger into Brown-Schaefer did not constitute a section 368(a)(1)(F) reorganzation. Held further, New Cannonsburg cannot carry back post-merger net operating losses to offset Old Cannonsburg's pre-merger net operating income.

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1 These cases were consolidated pursuant to an Order of this Court dated February 27, 1986.

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Held further, Brown-Schaefer takes a cost basis in the Old Cannonsburg stock acquired pursuant to a stock-for-stock exchange. Held further, Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock is a taxable exchange and not a tax-free reorganization. Held further, Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock does not qualify as a section 351 contribution to capital.

Walter J. Russell, for the petitioners.

Oksana O. Xenos, for the respondent.

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MEMORANDUM OPINION

WHITAKER, Judge: Respondent determined Cannonsburg Skiing Corporation (New Cannonsburg) to be liable, as transferee,[2] for deficiencies in Federal income tax of Cannonsburg Skiing Corporation (Old Cannonsburg), as transferor, for the years and in the amounts indicated:

Year[3]	Deficiency[4]
1977	$34,670.45
1978	52,656.19
1978[5]	61,499.41

Respondent determined a deficiency in Walter J. Russell's (Russell) and Mary Ann Russell's 1978 Federal income tax in the amount of $7,239.60.

After concessions, the issues presented for consideration are:

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2 The parties agree that New Cannonsburg is liable, as transferee of assets with a fair market value of $4,400,000, for the deficiencies in Federal income taxes finally determined or adjudged to be due and payable by Old Cannonsburg for the taxable years ended May 31, 1977, May 31, 1978, and October 31, 1978.

3 Fiscal year ended May 31.

4 In the event the Court sustains respondent's position that the 1978 merger of Old Cannonsburg into Brown-Schaefer Corporation constitutes a complete liquidation of a subsidiary within the meaning of sections 332 and 334(b)(2), I.R.C. 1954, as amended, petitioner concedes the correctness of all adjustments set forth in the notice of liability, upon which this case is based.

5 Final return for short year ending October 31, 1978.

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(1) Whether the merger of Old Cannonsburg (the acquired corporation) into New Cannonsburg (the acquiring corporation) constitutes a section 368(a)(1)(F)[6] reorganization (F reorganization);

(2) whether New Cannonsburg is entitled to carry back post-merger net operating losses to offset Old Cannonsburg's pre-merger net operating income;

(3) whether Brown-Schaefer Corporation (Brown-Schaefer) takes a cost basis or a carry over basis in Old Cannonsburg stock received pursuant to a stock-for-stock exchange;

(4) whether Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock constitutes a reorganization for purposes of section 354(a)(1); and

(5) whether Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock qualifies as a contribution to capital pursuant to section 351.

All of the facts have been stipulated pursuant to Rule 122, and are found accordingly. The Stipulation of Facts and attached exhibits are incorporated herein by this reference.[7]

Old Cannonsburg was a corporation organized under the laws of the State of Michigan on June 28, 1965. Old Cannonsburg's principal place of business was Belmont, Michigan, where it operated a ski resort. Russell and Mary Ann Russell, husband and wife, resided in Grand Rapids, Michigan, at the time their petition herein was filed. Russell was a shareholder of Old

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6 All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

7 The Stipulation of Facts in Docket No. 5211-83 (Russell) incorporates by reference the Stipulation of Facts and attached exhibits in Docket No. 5210-83 (New Cannonsburg).

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Cannonsburg from 1967 until October 24, 1978, on which date he surrendered his 1,857 shares of Old Cannonsburg stock for 3,233.2 shares of Brown-Schaefer stock.

From its incorporation until May 5, 1978, Old Cannonsburg's authorized stock consisted of 215,000 voting common shares, of which 118,157 were outstanding and owned as follows:

Shareholder	Number of Shares	Percent Interest
C. William Goff	103,800	87.85
John D. Bunbury	3,750	3.17
John Schermerhorn	3,750	3.17
Old Kent Bank as Trustee for Rosemary E. Thomas	5,000	4.24
Walter J. Russell	1,857	1.57
Total	118,157	100.00

On October 21, 1977, Paul W. Brown, Prentiss M. Brown, Jr., and Roy A. Schaefer (Brown Group) agreed to purchase 116,300 shares (approximately 98 percent) of outstanding Old Cannonsburg stock from C. William Goff, John D. Bunbury, John Schermerhorn, and Old Kent Bank as Trustee for Rosemary E. Thomas (Goff Group). Of the original shareholders, only Russell was not a party to the Stock Purchase Agreement (Agreement). The Agreement provided for a purchase price of $21.1583 per share (for a total of $2,460,710.26). A down payment equal to 20 percent of the purchase price was to be paid at closing. Additionally, $10,000 in earnest money was to be paid at the time the Agreement was signed. Such earnest money would be deducted from the 20-percent down payment, and promissory notes providing for annual payments on principal and interest were to

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be executed at the time of closing. The Agreement contemplated that the right to purchase would be assigned to a corporation wholly owned by the Brown Group.

Consummation of the stock purchase was contingent upon the Michigan Liquor Control Commission's approval of the transfer of Old Cannonsburg's liquor license and official permits to the buyers. The closing date was to be no later than 30 days subsequent to the Commission's approval. Due to the parties' inability to promptly obtain such approval, the Agreement was amended on January 31, 1978, as follows: (1) interest on the unpaid portion of the down payment was to accrue commencing October 1, 1977, and (2) interest on the principal balance was to accrue commencing December 1, 1977. Interest on the down payment was to be paid at closing and interest on the principal was to be paid as part of the first annual installment.

On February 6, 1978, Brown-Schaefer was organized under the laws of the State of Michigan. The Brown Group held equal one-third interests in stock subscription agreements for Brown-Schaefer's authorized capital stock. These same individuals comprised Brown-Schaefer's board of directors. Pursuant to the October 21, 1977, Agreement, they assigned their rights and interests under the Agreement to their newly formed and wholly owned corporation. Brown-Schaefer had no independent trade or business and the only assets it had prior to the purchase were funds provided by the Brown Group to be used as a down payment on the Old Cannonsburg stock.

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On March 1, 1978, Brown-Schaefer commenced active management of Old Cannonsburg. On May 5, 1978, Brown-Schaefer purchased approximately 98 percent of Old Cannonsburg's outstanding shares and the Brown Group became the sole members of Old Cannonsburg's board of directors. After the closing and until October 31, 1978, Old Cannonsburg was operated as a subsidiary of Brown-Schaefer.

The remaining 2 percent of Old Cannonsburg was owned by Russell. At the time Brown-Schaefer purchased its majority interest, Russell was secretary and attorney for Old Cannonsburg as well as a member of the board of directors. Russell had not, however, been actively involved in the management of Old Cannonsburg other than in his professional capacity as attorney adviser.

In the negotiations leading up to the October 21, 1977, Agreement, the Brown Group attempted to purchase Russell's 2-percent interest in Old Cannonsburg. Brown-Schaefer renewed the offer to purchase Russell's interest at the time the 98-percent stock purchase was consummated. Russell declined the offer on both occasions because he desired to retain an equity interest in Old Cannonsburg as an investment.

On October 23, 1978, a special meeting of the board of directors of Old Cannonsburg was held wherein a plan of reorganization was unanimously adopted. Integral to the plan of reorganization was the acquisition by Brown-Schaefer of Russell's 2-percent interest in Old Cannonsburg. To this end, a

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letter dated October 23, 1978, was hand delivered to Russell. The letter purported to constitute a plan of reorganization, and contained an offer to exchange Brown-Schaefer stock for Russell's Old Cannonsburg stock. In pertinent part, the letter reads as follows:

> This letter will constitute a Plan of Reorganization as required by IRS Regulation 1.368-3 and is to advise you that the Board of Directors of Brown-Schaefer Corporation has deemed it expedient to acquire all of the outstanding shares of Cannonsburg Skiing Corporation not previously acquired by Brown-Schaefer pursuant to the Stock Purchase Agreement of October 21, 1977. You are the only shareholder of Cannonsburg Skiing Corporation other than Brown-Schaefer and at the time of our purchase of the balance of the outstanding shares you declined to sell your shares because you wished to continue to have an interest in the business of Cannonsburg.
>
> Brown-Schaefer believes that it is in its best interest that Cannonsburg Skiing Corporation become a wholly owned subsidiary. However, realizing that you have no desire to terminate your interest in ownership of the business operated by Cannonsburg Skiing Corporation, we hereby offer to trade you shares of Brown-Schaefer Corporation for your Cannonsburg Skiing Corporation common stock.
>
> * * * Failure to accept the offer will, of course, leave Brown-Schaefer Corporation free to accomplish its purpose through other means.

On October 24, 1978, Russell accepted Brown-Schaefer's offer and surrendered his 1,857 shares of Old Cannonsburg stock for 3,233.2 shares (approximately 7 percent) of Brown-Schaefer's outstanding common stock.[8] Thus, on October 24, 1978, Old

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[8] The number of shares issued to Russell was arrived at by computing the ratio between the market value of Russell's shares as established by the sale to Brown-Schaefer and the amount of the down payment of $587,388.80, since the earnings of the corporation equating to all shares would be used to pay off the debt owed to the prior shareholders.

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Cannonsburg became a wholly owned subsidiary of Brown-Schaefer.

On the same day, a special meeting of the board of directors of Brown-Schaefer was held wherein a Plan of Merger of Old Cannonsburg into Brown-Schaefer was adopted. The relevant minutes of this meeting read as follows:

> The President, Paul W. Brown, stated that the Corporation has acquired one hundred percent (100%) of the outstanding capital stock of Cannonsburg Skiing Corporation and that the purchase of such stock was for the purpose of acquiring the assets of Cannonsburg Skiing Corporation, making such a wholly-owned subsidiary.
>
> Mr. Brown further stated that no purpose would be served by the continuation of the operation of Cannonsburg Skiing Corporation as a wholly-owned subsidiary of Brown-Schaefer Corporation and that counsel for the Corporation recommended that Cannonsburg Skiing Corporation be merged into Brown-Schaefer Corporation.

Pursuant to resolutions adopted by the board of directors of Old Cannonsburg and Brown-Schaefer, Old Cannonsburg was merged into Brown-Schaefer effective October 31, 1978. All shares of the authorized capital stock of Old Cannonsburg ceased to exist on the effective date of the merger and the name of the resulting corporation was changed to Cannonsburg Skiing Corporation (New Cannonsburg). New Cannonsburg was a corporation organized and existing under the laws of the State of Michigan and continued to operate the same business at the same location as had heretofore been operated by Old Cannonsburg.

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Old Cannonsburg had operated a ski resort on approximately 291 acres of land, which included a main lodge with ski shop, lounge, bar, dining rooms, and maintenance facilities. Related land improvements included lifts and tows, snow-making and grooming equipment, slope lighting, and landscaping. By virtue of Brown-Schaefer's purchase of 98 percent of Old Cannonsburg's stock, the merger of Old Cannonsburg into Brown-Schaefer constituted a complete liquidation pursuant to section 332, to which section 334(b)(2) applied. Thus, New Cannonsburg was entitled to a cost basis in Old Cannonsburg's assets. Old Cannonsburg's adjusted basis and New Cannonsburg's cost basis in the transferred real and tangible personal property (fixed assets) are set forth below:

Description	Old Cannonsburg's Adjusted Basis	New Cannonsburg's Cost Basis
Land	$ 260,614	$ 705,853
Landscaping	2,395	12,096
Sewage System	69,944	161,877
Buildings	493,271	1,548,322
Lifts & Tows	136,998	363,955
Slope Equipment	22,925	113,136
Rental Equipment	65,505	60,481
Snow Making	33,402	121,319
Grooming	42,165	143,376
Slope Lighting	44,609	109,222
Ski Slope Equip.	13,250	24,193
Furniture-Lodge	51,493	106,732
Furniture-Cafe	58,579	87,164
TOTAL	$1,295,150	$3,557,726

Subsequent to the merger, New Cannonsburg incurred net operating losses which it attempted to carry back to offset Old Cannonsburg's net operating income for the years at issue.

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OPINION

The parties agree that the merger of Old Cannonsburg into New Cannonsburg constitutes a complete liquidation of a subsidiary into its parent pursuant to section 332 and that New Cannonsburg takes a cost basis in Old Cannonsburg assets pursuant to section 334(b)(2). The first issue for consideration is whether New Cannonsburg is entitled to carry back post-merger net operating losses to offset Old Cannonsburg's pre-merger net operating income.

Section 381 governs the carry over of tax attributes in connection with certain corporate reorganizations and acquisitions. The "operating rules" set forth in section 381(b) impose certain limitations upon the extent to which a successor corporation steps into the "tax shoes" of its predecessor. Section 381(b)(3) provides that the transferee corporation shall not be entitled to carry back a net operating loss for a taxable year ending after the date of transfer to a taxable year of the transferor corporation ending before the date of transfer unless that transfer qualifies as an F reorganization.[9] Thus, the

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[9] SEC. 381(b). Operating Rules.--Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1)--

* * *

(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

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carry back of post-merger losses is contingent upon a finding that the merger of Old Cannonsburg into New Cannonsburg constitutes an F reorganization.

An F reorganization is defined as "a mere change in identity, form, or place of organization, however effected." This language strongly suggests that F reorganizations were meant to be limited to only minor corporate adjustments. Berger Machine Products, Inc. v. Commissioner, 68 T.C. 358 (1977). For the years at issue (1977 and 1978), however, the merger of a wholly owned subsidiary into its parent which qualifies as a liquidation under section 332 to which section 334(b)(2) does not apply can qualify as an F reorganization for purposes of section 381(b)(3).[10] Performance Systems, Inc. v. United States, 382 F.Supp. 525 (M.D. Tenn. 1973), affd. per curiam 501 F.2d 1338 (6th Cir. 1974); Eastern Color Printing Co. v. Commissioner, 63 T.C. 27 (1974). One underlying premise of all reorganizations is that there be significant continuing proprietary interest. The controversy in this case focuses upon the requirement of an identity of shareholders and their respective proprietary interests. This "continuity of interest" doctrine developed as a judicial embellishment of the reorganization provisions and is now codified in the applicable

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10 We note that Congress has amended sec. 368(a)(1)(F) to read as follows (applicable to transactions occurring after Aug. 31, 1982): "a mere change in identity, form, or place of organization of one corporation, however effected." (Emphasis added.) Tax Equity and Fiscal Responsibility Act of 1982, sec. 225, Pub. L. 97-248, 96 Stat. 324, 490.

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regulations, which provide that "[t]he term [reorganization] does not embrace the mere purchase by one corporation of the properties of another corporation for it imports a continuity of interest on the part of the transferor or its shareholders in the properties transferred." Section 1.368-2(a), Income Tax Regs. Thus, in order for a corporate combination to warrant tax-free reorganization treatment, the former owners of the acquired corporation must maintain a continuing proprietary interest in the acquiring corporation. See Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932), affg. 22 B.T.A. 808 (1931), cert. denied 288 U.S. 599 (1933). This Court, and the Sixth Circuit to which this case would be appealed, have emphasized the importance of continuity of shareholder interest in the context of F reorganizations, holding that a complete identity of shareholders and their proprietary interests is a prerequisite for F reorganizations. Performance Systems, Inc. v. United States, supra; Romy Hammes, Inc. v. Commissioner, 68 T.C. 900 (1977); Berger Machine Products, Inc. v. Commissioner, supra; but see Aetna Casualty & Surety Co. v. United States, 568 F.2d 811 (2d Cir. 1976).

Any test of the identity of shareholders and their proprietary interests must incorporate the step-transaction doctrine, wherein a series of formally separate steps are considered together as component parts of an overall plan. In Brown v. United States, 782 F.2d 559 (6th Cir. 1986), remanding 600 F. Supp. 47 (W.D. Ky. 1984), the Sixth Circuit adopted the

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"end result" test, which we will follow in this case. Golsen v. Commissioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir. 1971). Under the "end result" test:

> purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. * * * [Brown v. United States, supra, at 564, quoting King Enterprises, Inc. v. United States, 418 F.2d 511 at 516 (Ct. Cl. 1969), quoting Herwitz, Business Planning, 804 (1966).]

Thus, the Sixth Circuit clearly makes intent a necessary element for application of the step-transaction doctrine. A valid F reorganization therefore requires an identity of shareholders and their respective proprietary interests after related transactions have been integrated and treated as a whole.

With these requirements in mind, we turn to the facts of the transaction before us. The Brown Group's acquisition of Old Cannonsburg's business and assets involved the following three steps:

(1) The negotiations for 100 percent of Old Cannonsburg's stock, the agreement for purchase of 98 percent of the stock, and consummation of that agreement;

(2) the exchange of Russell's Old Cannonsburg stock for Brown-Schaefer stock; and

(3) the merger of Old Cannonsburg into Brown-Schaefer.

On these facts, the continuity of interest issue is basically one of timing and intent: at what stage in these transactions should the shareholders' proprietary interests be measured? New Cannonsburg contends that step one should be

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treated as being separate and distinct from steps two and three. By separating Brown-Schaefer's purchase from the subsequent exchange and merger, New Cannonsburg maintains that there was an identity of shareholders immediately before and after the merger, and that only a modest shift in proprietary interests occurred. In support of this argument, New Cannonsburg emphasizes the binding nature of the stock purchase agreement signed on October 21, 1977, and the passage of more than a year between the signing of the agreement and the merger of the corporations on October 31, 1978. It concludes that Brown-Schaefer's purchase of Old Cannonsburg stock should be viewed separately and not simply as a means of acquiring Old Cannonsburg's business and assets.[11]

Respondent takes the position that New Cannonsburg is not entitled to carry back its net operating loss because the merger of Old Cannonsburg into New Cannonsburg did not qualify as a reorganization within the meaning of section 368(a)(1)(F). He contends that, for the merger to qualify as such a reorganization, the continuity-of-interest requirement must be

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11 We note that this argument is fundamentally inconsistent with Brown-Schaefer's step-up in basis pursuant to sec. 334(b)(2), which is contingent upon a purchase followed by a liquidation. Congress' explicit intent in enacting sec. 334 was to codify the rule of Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), affd. per curiam 187 F.2d 718 (5th Cir. 1951), cert. denied 342 U.S. 827 (1951), that such an integrated transaction should be treated as the purchase of assets that in substance it is. See H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., A109 (1954); S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., 48 (1954); Cabax Mills v. Commissioner, 59 T.C. 401, 408-409 (1972).

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satisfied, that in applying such requirement, the step-transaction doctrine must be considered, that we must apply the continuity-of-interest requirement by looking to whether there was a continuity of interest of the historic shareholders of Old Cannonsburg and that when so applied, the continuity-of-interest requirement was not satisfied. Thus, respondent contends that steps one, two, and three should be collapsed under the step-transaction doctrine and treated as an acquisition by New Cannonsburg of Old Cannonsburg's assets.

In testing for continuity of shareholder interest, respondent argues that the Goff Group's proprietary interest in Old Cannonsburg before the stock sale must be compared with the Goff Group's proprietary interest in New Cannonsburg after the liquidation. Of course, the Goff Group had no post-liquidation proprietary interest in New Cannonsburg, having been "cashed out" at the time of the stock sale. Consequently, respondent claims that the continuity of interest requirement has not been satisfied, and that New Cannonsburg is not entitled to F reorganization treatment. We agree with respondent.

It is well established that the incidence of taxation depends not on the form but on the actual substance of a transaction. Commissioner v. Court Holding Co., 324 U.S. 331 (1945); Helvering v. Clifford, 309 U.S. 331 (1940). The step-transaction doctrine is a particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of a transaction. Gregory v. Helvering,

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293 U.S. 465 (1935). If, upon consideration of the intentions of the parties and the nature of the steps or parts of a transaction or transactions, it appears that what was accomplished should properly be treated for tax purposes as one transaction, that treatment will be adopted in accordance with the step-transaction doctrine. Brown v. United States, 782 F.2d 559 (6th Cir. 1986).

There has been no showing by New Cannonsburg that the Old Cannonsburg stock was not acquired as the first step in a plan to acquire Old Cannonsburg's assets. On these facts, we cannot view the purchase and liquidation as separate and independent steps. Steps one and two were necessary for Brown-Schaefer to obtain ownership of Old Cannonsburg as a wholly owned subsidiary, although the merger could have been affected, and Russell frozen out as a minority shareholder of Old Cannonsburg, without the acquisition of his stock. Brown-Schaefer's purchase of 98 percent of Old Cannonsburg's stock satisfied the 80-percent requirement contained in section 334(b)(2)(B) and thus guaranteed Brown-Schaefer a step-up in basis upon the liquidation of Old Cannonsburg. Having satisfied this prerequisite, the Brown Group merged Old Cannonsburg into Brown-Schaefer and took the desired step-up in basis. This was clearly their intent from the time negotiations for the purchase of Old Cannonsburg stock were commenced. The Old Cannonsburg stock was purchased for approximately three times its book value. The Brown Group could not afford to ignore the tax

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advantage to be derived from a section 334(b)(2) liquidation. Thus, while the existence of initial intent to liquidate is not a requirement for a step-up in basis, its presence warrants integration of steps one and three. The facts also mandate integration of step two.

In both the negotiations leading up to the Agreement, and at the time the Agreement was consummated, the Brown Group attempted to purchase Russell's interest in Old Cannonsburg. In its letter dated October 23, 1978, the Brown Group presented Russell with a "squeeze out" ultimatum; Russell must either exchange his Old Cannonsburg stock for Brown-Schaefer stock or Brown-Schaefer will be "free to accomplish its purpose through other means." The record does not reveal what "other means" were available to Brown-Schaefer, but we presume that the Brown Group could have eliminated Russell's minority interest by operation of state law.

The plan of merger was proposed and adopted on the same day Russell agreed to exchange his stock, and the merger was executed 1 week later. The formation of Brown-Schaefer, and the transfer to it of the Brown Group's rights under the Agreement, indicates an intent to merge the corporations in order to enjoy the benefits of a stepped-up basis. Brown-Schaefer's existence was necessitated by the mechanics of section 334(b)(2); New Cannonsburg could acquire a cost basis in Old Cannonsburg's assets through either an asset purchase or a stock purchase followed by a liquidation pursuant to section 334(b)(2). The

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merger technique is a recognized substitute for a simple corporate liquidation. Thus, the Brown Group's use of Brown-Schaefer as a means of obtaining a stepped-up basis in Old Cannonsburg's assets was sound.

After the transaction had been structured, the Agreement signed, and the liquidation accomplished, New Cannonsburg suffered operating losses. It is these losses which have caused New Cannonsburg to assert that the transaction constituted both a liquidation and a reorganization. We find this retroactive interpretation of a transaction which is straightforward on its face wholly unconvincing. As we have stated, when a transaction is composed of a series of related steps, each intended to achieve an overall objective, the various steps should be viewed in their entirety for the purpose of determining its tax consequences. Brown v. United States, supra. Thus, we conclude that Brown-Schaefer's acquisition of 100 percent of Old Cannonsburg's stock was inseparable from the subsequent merger of Old Cannonsburg into Brown-Schaefer. The integration of these transactions results in a 98-percent shift in ownership, which clearly violates the identity of shareholders and their proprietary interests as required for an F reorganization. Section 381(b), therefore, precludes any loss carry back by New Cannonsburg.

We must next determine Brown-Schaefer's basis in the 2 percent of Old Cannonsburg stock acquired from Russell in exchange for 7 percent of Brown-Schaefer's stock. This, in

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turn, will determine the amount of depreciation and investment tax credit recapture suffered by Old Cannonsburg upon liquidation. There is no dispute as to Brown-Schaefer's basis in, and Old Cannonsburg's recapture resulting from, the 98 percent of Old Cannonsburg stock purchased from the Goff Group.

New Cannonsburg contends that Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock constitutes a tax-free section 368(a)(1)(A) reorganization. Consequently, pursuant to section 362, Brown-Schaefer would take a carry over basis equal to Russell's basis in the Old Cannonsburg stock. Upon Old Cannonsburg's liquidation into Brown-Schaefer pursuant to section 334(b)(2), Brown-Schaefer's aggregate basis in Old Cannonsburg stock would determine the amount of Old Cannonsburg's depreciation and investment tax credit recapture, as well as Brown-Schaefer's basis in the real and tangible personal property acquired from Old Cannonsburg.

Respondent contends that Russell's exchange of Old Cannonsburg stock for Brown-Schaefer's stock constitutes a taxable transaction and not a tax-free reorganization. Thus, the amount of Old Cannonsburg's depreciation and investment tax credit recapture would be determined by the aggregate of Brown-Schaefer's cost basis in the stock purchased from the Goff Group plus a cost basis in the 2 percent acquired from Russell. Respondent determined New Cannonsburg's basis in the Old

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Cannonsburg stock by multiplying the total number of outstanding Old Cannonsburg shares by the price paid per share to the Goff Group.[12]

New Cannonsburg then argues that respondent's computation "grosses up" Brown-Schaefer's basis in Old Cannonsburg's stock by giving Brown-Schaefer a fair market value rather than a carry over basis in Russell's 2-percent interest. This "gross up" results in increased depreciation and investment tax credit recapture for Old Cannonsburg. The parties disagree only as to a cost basis or carry over basis for Russell's 2-percent interest. We agree with respondent that a cost basis is correct.

Pursuant to section 1001(c), a stock-for-stock exchange requires the recognition of gain unless otherwise provided.[13] Petitioner's contention that section 368(a)(1)(A) provides otherwise is incorrect. As discussed above, respondent correctly asserts that the requisite continuity of interest for reorganization is absent. In testing for continuity of shareholder interest, the courts have held that the requisite continuity is not fulfilled in the absence of a showing (1) that the transferor corporation or its shareholders retain a proprietary stake in the ongoing enterprise, and (2) that such

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12 Brown-Schaefer paid the Goff Group $21.1583 per share for 116,300 shares of Old Cannonsburg stock ($2,460,710.26).

13 SEC. 1001(c). Recognition of Gain or Loss.--Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

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retained interest represents a substantial part of the value of the property transferred. See generally LeTulle v. Scofield, 308 U.S. 415 (1940); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Southwest National Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir. 1951), affg. 14 T.C. 81 (1950); Kass v. Commissioner, 60 T.C. 218 (1973), affd. without published opinion 491 F.2d 749 (3d Cir. 1974). Russell is the only historic shareholder retaining an equity interest in New Cannonsburg. The 2-percent continuity of proprietary interest does not qualify as a reorganization.

Therefore, New Cannonsburg is entitled to a cost basis in the Old Cannonsburg stock under section 1012, and to an equivalent step-up in the basis of Old Cannonsburg assets under section 334(b)(2). Concomitantly, Old Cannonsburg is required to recognize ordinary income under the recapture provisions of sections 1245 and 1250 and to increase its income tax to reflect recaptured investment tax credit under section 47(a) based on a cost basis for Russell's 2-percent interest.

We must next decide whether Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock constitutes a reorganization for purposes of section 354(a)(1). Thus, we are looking at the shareholder's end of the same stock-for-stock exchange discussed above. Russell contends that his exchange of Old Cannonsburg stock for Brown-Schaefer stock constitutes a reorganization, and is therefore tax free to him pursuant to section 354(a)(1). Respondent contends, however, that the

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stock-for-stock exchange does not qualify as a reorganization because it fails the continuity-of-interest test and that, consequently, Russell falls outside of section 354(a)(1) and must recognize gain pursuant to section 1002.[14] For the same reasons discussed at length above, we again decide the issue for respondent.

Section 354(a)(1) governs the recognition of gain or loss to exchanging shareholders in a reorganization. A transaction must constitute a reorganization, however, before taxpayers can resort to the nonrecognition rules of section 354. Turnbow v. Commissioner, 368 U.S. 337 (1961). Brown-Schaefer's May 5, 1978, purchase of 98 percent of Old Cannonsburg's stock and Russell's October 24, 1978, exchange of Old Cannonsburg stock for Brown-Schaefer stock are two steps in the same transaction. The transaction fails the continuity-of-interest test and falls outside of the nonrecognition provisions of section 354(a)(1). Thus, we look to the historic shareholders, the Goff group, rather than to Brown-Schaefer's stockholdings to measure the continuity-of-interest. Therefore, Russell's claimed reorganization must fail. See Kass v. Commissioner, supra.

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14 SEC. 1002. RECOGNITION OF GAIN OR LOSS.

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

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We must next decide whether Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock qualifies as a contribution to capital pursuant to section 351.

Russell contends that his exchange of Old Cannonsburg stock for Brown-Schaefer stock constitutes a mere change in the form of his investment and not a cashing in of his potential gain on the investment. He cites Portland Oil Co. v. Commissioner, 109 F.2d 479 (1st Cir. 1940), affg. 38 B.T.A. 757 (1938), for the proposition that the capital contribution provisions were enacted to save the taxpayer from an immediate recognition of gain where the gain may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership. Respondent contends that petitioner fails to satisfy the requirements of section 351 and, consequently, is not entitled to nonrecognition treatment. Section 351 extends full nonrecognition of gain or loss to transfers of property by one or more persons to a corporation solely in exchange for such corporation's stock or securities, if the transferor (or transferors) are in control of the corporation immediately after the exchange.[15] "Control" is defined by section 368(a)(1)(C) as being at least 80 percent of

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15 SEC. 351(a). General Rule.-- No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

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the combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of each nonvoting class of stock of the corporation. See section 1.351-1(a)(1), Income Tax Regs.

Respondent asserts that Russell failed to satisfy the section 351 "control" requirement, and is thus precluded from nonrecognition treatment. We agree with respondent. Russell's exchange of 2 percent of Old Cannonsburg's stock for 7 percent of Brown-Schaefer's stock, when viewed in isolation, clearly fails the section 368 control requirement. The Court's reasoning in Portland Oil Co. v. Commissioner, supra, applies only to transactions which otherwise satisfy the capital contribution provisions. Thus, Russell's inclusion in the control group is a prerequisite to nonrecognition.

Russell contends, however, that by application of the step-transaction doctrine, his exchange of Old Cannonsburg stock for Brown-Schaefer stock should be integrated with the Brown Group's contributions of cash for Brown-Schaefer stock. Thus, cash and stock would have been contributed by the Brown Group and Russell in exchange for 100 percent of Brown-Schaefer's stock. That transaction would, on its face, appear to satisfy section 351. To be in control "immediately after the exchange" as required by section 351 "does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously

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defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Section 1.351-1(a)(1), Income Tax Regs.

This argument fails, however, because it was not the intention of the Brown Group at the time the transaction was entered into to include Russell as a shareholder of Brown-Schaefer. At paragraph 2.2, the Agreement states as follows:

> In the event this Agreement shall be assigned by the Purchaser as hereinafter provided to a corporation of which they shall own 100% of the outstanding capital stock (hereinafter referred to as Purchasing Corporation) that such Purchasing Corporation will make the representations and warranties as contained in Paragraph 3.0 below. [Emphasis added.]

The Brown Group was the purchaser for purposes of the Agreement. Thus, Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock at the formation of Brown-Schaefer would have constituted a breach of paragraph 2.2 at the time the Agreement was assigned to Brown-Schaefer. Additionally, the Brown Group's attempts to purchase Russell's stock at the time the Agreement was signed, and again at the time the Agreement was consummated, demonstrates the lack of intent to include Russell in the cash for stock exchange at the formation of Brown-Schaefer. Though Brown-Schaefer's purchase of the Goff Group's stock and the subsequent merger of Old Cannonsburg into Brown-Schaefer were related events, Russell's exchange of Old Cannonsburg stock for Brown-Schaefer stock was not an intended part of the Brown-Schaefer incorporation transfer made by the Brown Group. American Bantam Car Co. v. Commissioner, 11 T.C.

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397, 405-407 (1948), affd. per curiam 177 F.2d 513 (3d Cir. 1949), cert. denied 339 U.S. 920 (1950). As we stated in Kass v. Commissioner, 60 T.C. 218, 226 (1973), affd. without published opinion 491 F.2d 749 (3d Cir. 1974):

> This result merely illustrates the truism that the step-transaction doctrine, even when worded consistently * * * and applied to identical facts, may result in integration in one case and "separateness" in another case simply because the legal question to be answered has changed. See King Enterprises, Inc. v. United States, 418 F.2d 511, 516-519 (Ct. Cl. 1969).

Russell has only himself to blame for this consequence. He insisted upon maintaining his status as a shareholder of Old Cannonsburg until after the formation of Brown-Schaefer. It was then too late to become a participant in the section 351 transaction. We again decide the issue for respondent.

Decisions will be entered for respondent.

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T. C. Memo. 1986-151

UNITED STATES TAX COURT

RALPH S. NORRIS, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 11344-83. Filed April 16, 1986.

Held: Petitioner held real estate primarily for sale in the ordinary course of his trade or business and profits from sales of such real estate constitute ordinary income; petitioner's profits from real estate sales in 1973 and 1978 are decreased by costs of renovations and repairs; amount of 1978 loss attributable to theft of coin collection determined; and petitioner liable for additions to tax pursuant to sections 6651(a), 6653(a), and 6654.

Ralph S. Norris, pro se.

Christine Colley, for the respondent.

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MEMORANDUM FINDING OF FACTS AND OPINION

WHITAKER, Judge: Respondent determined deficiencies in petitioner's Federal income tax and additions to tax as follows:

		Additions to Tax		
Year	Deficiency	6651(a)(1)[1]	6653(a)	6654
1973	$ 1,072	$ 268	$ 53	$ 34
1974	6,066	1,516	303	194
1976	3,709	927	185	138
1977	2,035	509	102	73
1978	21,408	-	1,070	-
1979	517	129	51	-

After concessions by the parties, the issues for decision are:

(1) Whether petitioner held real estate primarily for sale to customers in the ordinary course of a trade or business, thereby requiring profits from the sales of such property to be reported as ordinary income;

(2) whether petitioner's profits from sales of certain real estate in 1973 and 1978 should be decreased by costs of renovations and repairs;

(3) whether petitioner is entitled to a theft loss deduction in 1978 and, if so, the amount of the deduction; and

(4) whether petitioner is liable for additions to tax pursuant to sections 6651(a), 6653(a), and 6654.

FINDINGS OF FACTS

Some of the facts have been stipulated and are so found. The stipulation and attached exhibits are incorporated herein by this reference. Petitioner resided in North Leeds, Maine, at the time his petition was filed.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, and all rule references are to the Tax Court Rules of Practice and Procedure.

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Petitioner began purchasing real estate in 1969 with funds borrowed from his mother, uncle, and banks. With the exception of $88 in 1978 and $609 in 1979 , petitioner's sole source of income during the years in issue was his real estate activities. Petitioner's real estate activities generally involved locating and purchasing property, making necessary improvements, renovations, and/or repairs and, after holding the property for the period necessary to qualify for long-term capital gain treatment,[2] selling it.

In 1970 petitioner obtained a real estate broker's license which he kept active until 1980. After obtaining this license, petitioner undertook to sell a few parcels of property for third parties. He found this unprofitable and, thereafter, his real estate sales, as well as purchases, were exclusively on his own behalf. With the exception of three to four pieces of property sold by other brokers, petitioner made all 39 sales of his real estate during the years 1973 through 1979.

Petitioner's real estate activities kept him on the road every day trying to locate appropriate property and doing necessary improvements, renovations, and repairs. He was involved in negotiating all aspects of both the purchase and sale of his real estate. Petitioner maintained an office in his home which he used in the conduct of his real estate activities.

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[2] Petitioner's holding period was less than the statutory holding period as to three pieces of property accounting for profits of $1,850 in 1973 and $2,476 in 1974. As to these sales, petitioner would not be entitled to long-term capital gain treatment under any scenario.

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Generally, some improvements, renovations, or repairs were necessary to increase the salability of each piece of property petitioner purchased. As petitioner stated "* * * basically, any parcel of property you have, you buy, something has to be done to it before you can sell it." If the property was raw land, such improvements might include surveying and marking the property lines, hauling gravel for a road into the property, and/or having debris hauled away and "clean[ing] up" the land.

When petitioner acquired improved[3] property, he generally undertook to "redo" with the cheapest materials possible so that he could "get rid of the property." In some, if not all, instances petitioner located his improved real estate purchases through the Farmers Home Administration which notified him when they had an abandoned or repossessed home on which he could bid. The renovations and repairs he made to these properties were necessitated by the fact that the buildings were not in a habitable, i.e., resalable, condition when he purchased them. It usually took about 2 years to get this type of property ready for resale and encompassed significant renovations or repairs. For example, on September 3, 1970, petitioner purchased a single family dwelling of six rooms and a bath which had been abandoned. Prior to resale in July 1973, renovations at a cost of approximately $3,000 had been made, which included repair of the

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[3] As used in this opinion the term "improved" property refers to property on which a building existed at the time of purchase and sale.

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furnace, installation of new bathroom fixtures and a sink in the kitchen as well as replacing all of the pipes and faucets. Similarly, in August 1975, petitioner purchased a single family three-story dwelling which he converted into two full apartments and a smaller 2-room attic apartment prior to resale in September 1978. Since the building was gutted when purchased, these renovations included installation of three bathrooms with all new fixtures, new cabinets, carpeting and plywood paneling throughout, insulation, and windows and repair of the furnace and heating system. These renovations cost approximately $14,000. Again, prior to petitioner's September 1, 1978, resale of improved property he had purchased in 1970, substantial repairs including installation of an asphalt shingle roof, a brick chimney, porch, window sills, and cedar shingle siding for the entire building at an aggregate cost of approximately $6,000, were required. Finally, the single-family home petitioner sold on March 10, 1978, required the following repairs prior to resale: installation of a new bathroom including tub, lavatory, and tile; new kitchen cabinets; and carpeting in the living room and upstairs. These repairs cost approximately $3,000.[4]

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[4] Documentary substantiation of the costs of renovations and repairs during 1973 and 1978 was lost when petitioner's home was burglarized in 1978. Additional difficulties in reconstructing the precise costs of these renovations and repairs were due to petitioner's impaired memory as a result of a head injury suffered in an accident a few years before trial.

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Petitioner generally rented improved property during the period he was making or completing renovations and repairs or while locating a buyer. Of the six parcels of improved property sold by petitioner during the years in issue, at least four were occupied prior to sale. In two of these instances, petitioner was unable to collect any rent. The improved property sold in 1977 was occupied by the buyer for approximately 2 years prior to sale but the record does not indicate whether the rent paid during this period was applied to the purchase price or at what point during the occupancy the sale was negotiated. By 1979 petitioner had sold all of his improved real estate and, therefore, had no rental income in later years.

To facilitate sales, petitioner advertised in local and out-of-state newspapers and some magazines. While buyers would frequently become interested in improved property while petitioner was working on it, most property was sold through some type of advertisement. In July 1974, petitioner bought a helicopter to use in his real estate activities. He advertised in the New York Times for potential buyers whom he would pick up at the local airport and, via helicopter, show available property. He sold two pieces of real estate in this manner. In 1976 he sold the helicopter at a gain of $2,600 having found this method of sale too costly.

In computing petitioner's income from real estate activities, respondent allowed deductions for business expenses such as advertising, insurance, interest, taxes, license fees, gas, and oil as follow:

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Year	Amount
1973	$ 4,637
1974	6,217
1975	12,075[5]
1976	8,557
1977	8,195
1978	11,804
1979	9,485

Petitioner, of course, preferred cash buyers. However, if he could not find a cash buyer, he would get as large a down payment as possible and finance the balance of the sale price. The following tables reflect the details of petitioner's real estate sales:[6]

INSTALLMENT SALES

Year	Date Acquired	Date Sold	Sale Price	Gain/ (Loss)
1973	9/3/70*	7/1/73	$ 7,000	$ 0
1974	7/1/72	2/8/74	11,000	7,000
	1/18/73	9/3/74	22,000	13,736
	4/7/69	4/8/74	3,500	2,336
	6/28/72	1/5/74	6,500	3,500
	10/8/73	4/74	5,000	2,736
1975	8/1/74	8/75	6,500	3,650
	4/24/73	12/4/75	6,000	3,600
1976	12/6/74	5/76	4,500	2,500
	12/14/72	12/18/76	10,000	6,600
	9/14/73			
	12/3/74	8/76	4,500	2,550
1977	4/22/74	7/77	8,000	5,667
	7/22/74*	9/1/77	14,000	10,500
	6/11/71	9/15/77	3,000	1,500
	10/8/73	4/77	7,000	5,500
1978	8/19/75*	9/12/78	18,000	500
	1970*	9/1/78	14,000	4,500
1979	-	-	-	-

[5] Although 1975 is not a year before the Court, this year forms part of the pattern of petitioner's real estate activities and is included in our findings as relevant to our determination of the issues before us.

[6] Adjustments to the amount of gains stipulated by the parties have been made to reflect the costs of repairs and renovations on certain improved properties sold in 1973 and 1978 discussed supra.

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COMPLETED SALES

Year	Date Acquired	Date Sold	Sale Price	Gain/ (Loss)
1973	6/26/72*	5/7/73	5,500	675
	5/10/73	8/23/73	4,000	675
	10/26/71	5/24/73	5,000	3,275
	5/15/72	2/24/73	5,500	3,500
	1/3/73	5/15/73	6,000	1,175
	2/17/71	4/23/73	3,000	-
1974	10/1/71	12/6/74	5,000	-
	10/1/71	9/27/74	12,000	5,236
	3/29/72	3/24/74	12,500	7,500
	6/2/72	3/20/74	5,015	3,515
	4/74	11/74	8,000	(265)
	4/74	4/74	4,000	2,476
1975	3/20/70	4/24/75	1,000	(2,050)
	1/3/73	8/22/75	9,000	3,950
1976	5/21/71	3/5/76	3,000	2,750
	2/8/74	5/76	10,000	5,000
	7/1/73	1976	2,500	-
1977	-	-	-	-
1978	11/17/75*	3/10/78	10,000	2,500
	8/7/73	5/15/78	1,800	300
	9/3/76	5/24/78	55,000	38,000
	1974	1978	6,508	4,198
1979	1974-76	1979	10,487	3,071

The asterisked sales in the above tables were of improved property.[7] During the years 1973 through 1979 petitioner's aggregate real estate sales were $335,310 with an aggregate gain of $161,856.[8]

Petitioner's income from his real estate activities during the years in issue, was as follows:

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[7] The record is silent as to petitioner's real estate activities for the years 1980 and thereafter. As of trial on May 3, 1984, petitioner owned five parcels of real estate which he was in the process of selling.

[8] These figures differ from those stipulated by the parties due to the fact that the stipulation failed to reflect the details of the 1979 completed sale and certain 1973 and 1978 renovation and repair costs (see n. 6).

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	1973	1974	1975	1976	1977	1978	1979
Completed Sales	$ 9,300	$18,462	$ 1,900	$ 3,250	-	$47,998	$ 3,104
Installment Sales - Principal[9]	$79	7,535	2,583	4,324	4,232	13,265	-
Installment Sales - Interest	527	2,181	4,202	5,988	8,387	9,896	14,010
Rent	390	-	3,120	3,736	5,320	7,959	-
	$10,296	$28,178	$11,805	$17,298	$17,939	$79,118	$17,114

On January 10, 1978, petitioner's house was burglarized and a gun collection and safe containing petitioner's real estate documents and a coin collection were stolen. In petitioner's absence, the burglary was reported to the Sheriff's office by petitioner's neighbor who identified herself as the caretaker. The investigating officer interviewed this neighbor, her husband, and a third acquaintance of petitioner. The "caretaker" specified that among the safe's contents was petitioner's coin collection "worth around $20,000."[10] On his 1978 Federal tax return, petitioner claimed he had suffered a $15,357 loss as a result of the burglary.[11] Of this amount, petitioner's insurance

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9 Includes principal payments on installment sales in prior years.

10 The Complaint Report of the investigating officer, based on statements of the caretaker, lists additional contents of the safe as bonds (worth approximately $8,000), around $3,000 in cash, an unknown amount of jewelry and real estate papers. The accuracy of this report, and the caretaker's account, is questionable as the purportedly stolen bonds, cash, and jewelry were never mentioned during trial or, apparently, to petitioner's insurance company.

11 Petitioner's vague explanation of why the claimed loss was less than the value he placed on his coin collection at trial, i.e., that he claimed a lesser amount to avoid any challenge, was, at best, contrived.

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company paid $5,357 to cover the loss of his gun collection and damage to the house. No reimbursement was made for his papers or coins. Petitioner did not include the coin collection in his claim to the insurance company ostensibly because he had failed to separately insure it. Petitioner claimed a deduction of $9,900 on his 1978 return which purportedly represented the estimated cost of the coin collection comprised mostly of old silver dollars. Petitioner asserts he had collected coins "all" of his life and estimated that he had "put" over $20,000 into his collection. However, with the exception of a $400 purchase from a coin dealer in Lewiston, Maine, in December 1977, petitioner offered no details or enlightenment as to any facts he relied on in "figur[ing]" the cost of his coin collection.

In 1973 petitioner took his tax materials to Guilmet Realty and was advised by an unidentified person that, if his net income was less than $1,700, he should not file a tax return. Since from his perspective he did not start making money from his real estate activities until 1978,[12] petitioner failed to file income tax returns for the years 1973 through 1977. A timely return was filed for 1978. Although no application for extension was made, petitioner's 1979 return was not filed until August 29, 1980.

In the February 14, 1983, statutory notice of deficiency, respondent reconstructed petitioner's income for the years in issue and determined additions to tax pursuant to sections

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12 From 1973 through 1977, petitioner borrowed money "to live on" from his parents, although during at least some of these years he made numerous real estate purchases.

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6651(a), 6653(a), and 6654. The parties' disagreement as to gross profit reflects the cost of renovations and repairs to improved properties sold during 1973 and 1978 discussed in detail supra.[13] The 1978 itemized deduction of $8,585 in dispute is attributable to the purported coin collection loss. Additionally, the parties disagree as to whether petitioner's profits from real estate sales should be taxed at capital gain or ordinary income rates.

OPINION

The first issue presented for our decision is whether 35 parcels of real estate sold by petitioner during the years in issue were capital assets within the meaning of section 1221. If so, petitioner's profits on these sales are entitled to the preferential treatment afforded capital gains. Section 1202. To resolve this issue, we must look to the definition of a capital asset. Section 1221 provides, in pertinent part, that:

> the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include--
>
> (1) * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business * * *

Because the capital gain provisions represent "an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its

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13 Notwithstanding the fact that petitioner stipulated to the accuracy of the 1973 adjustment, the parties' dispute as to this item was fully tried and briefed by respondent. We, therefore, deem the stipulation corrected in this regard and the adjustment for 1973 properly before the Court.

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exclusions interpreted broadly" in order "to effectuate the basic congressional purpose." Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52 (1955); Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134 (1960); Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958). Petitioner bears the burden of proof to establish that the properties he sold were capital assets. Bynum v. Commissioner, 46 T.C. 295, 298 (1966); Municipal Bond Corp. v. Commissioner, 46 T.C. 219, 228 (1966), affd. in part and revd. in part, 382 F.2d 184 (8th Cir. 1967); Rule 142(a).

Section 1221(a) requires that, to determine if petitioner's profits from the sale of real estate are entitled to capital gain treatment, three questions must be answered: (1) what was petitioner's trade or business; (2) did petitioner hold the property primarily for sale in that business; and (3) were the sales "ordinary" in the course of that business? Suburban Realty Co. v. United States, 615 F.2d 171, 178 (5th Cir. 1980). As to the second question, in Malat v. Riddell, 383 U.S. 569, 572 (1966), the United States Supreme Court clarified the meaning of the phrase "primarily for sale" as follows:

> The purpose of the statutory provision * * * is to differentiate between the "profits and losses arising from the everyday operation of a business" on the one hand * * * and "the realization of appreciation in value accrued over a substantial period of time" on the other. * * * A literal reading of the statute is consistent with this legislative purpose. We hold that, as used in § 1221(1), "primarily" means "of first importance" or "principally." [Citations omitted.]

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In making the requisite inquiries, all relevant facts and circumstances must be considered. Redwood Empire Sav. & Loan Asso. v. Commissioner, 68 T.C. 960, 971 (1977), affd. 628 F.2d 516 (9th Cir. 1980).

Before turning to the controlling questions, we note that, in cases such as this, courts frequently make separate findings as to each of a taxpayer's real estate transactions rather than reaching a general conclusion as to the taxpayer's status as a dealer or investor on all sales. Municipal Bond Corp. v. Commissioner, 382 F.2d 184, 186 (8th Cir. 1967).[14] Such an approach to individual transactions may be necessary because a taxpayer active in the real estate business, such as petitioner, may hold real estate as an investment. Eline Realty Co. v. Commissioner, 35 T.C. 1, 5 (1960); Mieg v. Commissioner, 32 T.C. 1314, 1321 (1959). In the instant case, however, neither party has focused on the individual properties to an extent which would permit a property-by-property analysis. Further, the record does not indicate that petitioner's intent or purpose in acquiring, holding, or selling differed by property. Although certain parcels of property were held for relatively long periods of time, the record does not indicate whether these holding periods were due to difficulty in finding an acceptable buyer, the time required for extensive renovations and repairs, or some other undisclosed reason.

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14 See also, Estate of Dean v. Commissioner, T.C. Memo. 1975-137; Wilson & Fields v. Commissioner, T.C. Memo. 1962-200.

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Relevant factors considered in determining whether property is held primarily for sale to customers in the ordinary course of business include: (1) the frequency, continuity, and substantiality of sales; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the time and effort the taxpayer habitually devoted to the sales; (4) the extent of improvements and advertising to increase sales; and (5) the nature and purpose of the acquisition of the property and the duration of ownership.[15] United States v. Winthrop, 417 F.2d 905, 909-910 (5th Cir. 1969); Biedenharn Realty Co. v. United States, 526 F.2d 409, 415 (5th Cir. 1976); Daugherty v. Commissioner, 78 T.C. 623, 629 (1982); Adam v. Commissioner, 60 T.C. 996, 999 (1973). No one or combination of the above factors is determinative.

The frequency, continuity, and substantiality of real estate sales by petitioner during the years in issue is a strong indicator that petitioner was in the business of buying and selling real estate and held the property sold primarily for sale to customers in the course of that business. Suburban Realty Company v. United States, supra at 178; Biedenharn Realty Company, Inc. v. United States, supra at 416. Petitioner, without citing any authority or precedent, argues that the frequency of his sales was less than a dealer's. We disagree.

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15 Other factors frequently considered which are not relevant to our decision in this case are: (1) the extent of subdividing and development to increase sales; (2) the use of a business office for the sale of the property, and; (3) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property.

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During the years 1973 through 1979, petitioner made 39 real estate sales--an average of between five and six sales per year. In the peak sales year, 1974, petitioner made 11 such sales. Sales of comparable frequency have been found to be dealer, rather than investor, sales.[16] Petitioner's real estate sales evidence a continuous, and relatively consistent, pattern of business activity during the years 1969 through 1979. Such sales were substantial--totaling $335,310 and representing $161,856 profits. During the years in issue, petitioner's real estate activities were, effectively, his only source of income.

The extensive solicitation and advertising efforts undertaken by petitioner, as well as his dedication of time and energy to his real estate pursuits, also supports a conclusion that his real estate holdings were not capital assets. He obtained a broker's license to facilitate his real estate endeavors, negotiated all aspects of his real estate purchases and sales and, from 1973 through 1979, personally made approximately 90 percent of these sales. He advertised extensively and purchased a helicopter specifically to facilitate sales to out-of-state buyers. From 1969 through at least 1979, petitioner's sole occupation was his real estate business.

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16 See Urick v. Commissioner, T.C. Memo. 1983-60 (30 lots sold over 11 years); Enslin v. Commissioner, T.C. Memo. 1982-430 (an average of 8 sales per year); Maginnis v. Commissioner, T.C. Memo. 1955-250 (37 sales over 7 years with a maximum of 7 sales in each of 2 peak years).

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The improvements, renovations and/or repairs petitioner generally made to each property he purchased further indicate that petitioner's properties were not capital assets. He expended significant time, effort, and money on these improvements, renovations and/or repairs for the explicit purpose of enhancing his properties' salability.

In seeking preferential treatment of his profits on real estate sales, petitioner argues that his intent in acquiring the properties was that of an investor. In support of this contention, petitioner cites the fact that he generally held the property in excess of the statutorily required holding period.[17] Merely holding property for a prescribed period of time does not act as a talisman to insulate profit on subsequent sale of the property from taxation as ordinary income.[18] The duration of ownership is but one of the relevant facts and circumstances which must be considered.

Petitioner further argues that in acquiring real estate his intent was to generate income from rents and a stream of income from installment sales. The record does not support this argument. The vast majority of petitioner's real estate acquisitions were of unimproved land and the record does not indicate such property ever generated any rental income or that

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17 The applicable holding period for long-term capital gain treatment prescribed in section 1222(3), was 6 months for years prior to 1977, 9 months for 1977, and 1 year for 1978 and 1979.

18 E.g., Urick v. Commissioner, supra (lots held over 10 years); Herndon v. Commissioner, T.C. Memo. 1968-135 (lots held over 20 years).

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petitioner made any efforts to rent his unimproved property. Further, petitioner's rental income was insignificant in relation to his profit from the sale of property.[19] Although some of the improved properties sold by petitioner during the years in issue generated rent at some period, this was generally incidental and occurred during the period petitioner was renovating the building for sale or searching for a viable buyer. Incidental rental income does not convert property held as a dealer into property held for investment. See Municipal Bond Corp. v. Commissioner, 46 T.C. 219 (1966), affd. in part and revd. in part 382 F.2d 184 (8th Cir. 1967).[20] Petitioner made no effort to build an inventory of rental property. In fact, by 1979, he had sold all of his improved property and, thereafter, had no rental income. The evidence also does not support petitioner's contention that one of his primary purposes in his real estate activities was to generate a stream of income from installment sales. Although petitioner frequently provided financing to his buyers, he preferred, and sought, cash buyers. The majority of his sales were completed rather than installment sales and were, therefore, contra to this stated objective.

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19 We note in this regard that it is impossible to determine from the record whether the rental income stipulated by the parties is attributable solely to the property sold during the years in issue.

20 See also, Vidican v. Commissioner, T.C. Memo. 1969-207; Maginnis v. Commissioner, supra; Goodman v. Commissioner, T.C. Memo. 1954-43.

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As to the third question in our analysis, whether the sales were in the ordinary course of petitioner's business, we agree with respondent that the sales in issue were not only ordinary but "the sole object" of petitioner's business. In assessing whether said sales were "ordinary" the inquiry is whether such sales activities were "usual or a departure from the norm." United States v. Winthrop, supra at 912. The history and chronology of petitioner's real estate sales demonstrate that the sales were usual. Such sales continued over a number of years. In Suburban Realty Company v. United States, 615 F.2d 171, 178 (5th Cir. 1980), the frequency and substantiality of sales was cited as the key factor in determining the "ordinariness" of property sales. This factor was discussed supra and supports our conclusion that petitioner's sales were in the ordinary course of his real estate business. Additional factors supporting this conclusion are that the sales and advertising were handled directly by petitioner and that the real estate sales activities were petitioner's only business during the years in issue.

Based on the entire record, we conclude that petitioner held each of the properties sold during the years in issue primarily for sale to customers in the ordinary course of his real estate business. Therefore, profits from such sales are taxed as ordinary income.

The next issue we address is petitioner's assertion that gross profits from realty sales in the years 1973 and 1978 are overstated because respondent failed to consider the costs of

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major renovations and repairs made to certain improved properties. Petitioner bears the burden of proof with regard to these adjustments. Rule 142(a); Welch v. Helvering, 290 U.S. 111 (1933). Documentary substantiation of the costs in issue was lost when petitioner's home was burglarized in 1978. Respondent concedes that there is no doubt that certain improvements may have been made but asserts that petitioner's uncorroborated and self-serving testimony is insufficient to justify any adjustment. We disagree.

We note that petitioner undertook to represent himself. Hence, during trial, the Court sought to elicit from him details concerning the specific repairs undertaken on each piece of property and the cost of said repairs. Although petitioner's memory was impaired due to a head injury, his testimony as to these costs was entirely credible. He provided sufficient details as to the specific renovations and repairs as to each piece of property, and realistic approximations of their costs, to warrant allowance of adjustments in 1973 and 1978. While imprecision exists, relying on Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930), we have found above that petitioner expended $3,000 for repairs of property sold in 1973 and $23,000 for renovations and repairs of properties sold during 1978 which respondent failed to take into account. Petitioner's profits from real estate sales during said years should, therefore, be decreased to reflect these costs.

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We next address the issue of petitioner's claimed theft loss deduction. Under section 165, an individual may deduct losses resulting from theft of property to the extent the loss exceeds $100 and is not compensated by insurance or otherwise. The amount of the deduction is the lesser of (1) the fair market value of the property immediately before the loss reduced by its fair market value immediately after the loss, or (2) the adjusted basis of the stolen property. Sections 1.165-7(b)(1) and 1.165-8(c), Income Tax Regs. In the instant case, the basis of the property is its cost. Section 1012.

Although other items were stolen, the theft loss deduction in issue is attributable solely to petitioner's coin collection. Respondent argues that petitioner is not entitled to this deduction as he has failed to establish:

(1) that he did, in fact, own a coin collection;

(2) the alleged purchase price of the collection;

(3) the fair market value of the collection on January 10, 1978, (the date of the purported theft); and

(4) that a theft, in fact, took place.

Petitioner must prove that a theft occurred and that he was the owner of the property stolen. Elliott v. Commissioner, 40 T.C. 304, 311 (1963); Draper v. Commissioner, 15 T.C. 135 (1950). We accept petitioner's testimony, which is corroborated in part by the Sheriff's Office Complaint Report and the insurance reimbursement, that his home was burglarized in 1978 and certain coins he owned were among the items stolen.

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In order to establish his entitlement to the claimed deduction, however, petitioner must also prove the amount of the loss. Pfalzgraf v. Commissioner, 67 T.C. 784, 787 (1977). With the limited exception of his $400 coin purchase in late 1977, petitioner failed to provide details or any credible evidence of either the value or cost of the stolen coins. His conclusory testimony is inadequate to fill this evidentiary gap. In this regard, we note that petitioner failed to insure his coin collection which he valued at $20,000, failed to mention any coin collection on his insurance loss claim, and initially claimed that the total loss suffered as a result of the burglary was only $15,357. Petitioner would have the Court believe that he owned and, in fact, annually added to, a valuable coin collection during years when he was forced to borrow money from his family to live on and to purchase real estate. We decline to do so. As petitioner has failed to prove that the value of the coins stolen in 1978 exceeded $400, we hold that his unreimbursed theft loss in 1978 was $400.[21]

Having resolved the substantive issues in dispute, we now address the additions to tax.[22] On brief petitioner failed to

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21 The record is silent as to the fair market value of these coins on the date of the theft. However, as the coins were purchased approximately 1 month before the theft, we find that their fair market value when stolen was not less than cost.

22 On brief, petitioner argued that the rental income calculated by respondent was incorrect and that certain amounts designated rental income were sales proceeds. He further asserts that "the Court did consider Mr. Norris' claim to this and did make adjustments accordingly." In fact, petitioner stipulated to the accuracy of respondent's calculation of rental income and,
(footnote continued)

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address the individual additions to tax determined by respondent stating in a conclusory fashion that "penalties of $5,552 which under the circumstances are excessive," should be disallowed in their entirety.

Section 6651(a) imposes an addition to tax for failure to file a timely return unless it is shown that such failure is due to reasonable cause and not willful neglect. Petitioner has the burden of showing reasonable cause for an untimely filing. Rule 142(a); BJR Corp. v. Commissioner, 67 T.C. 111, 130-131 (1976); Elliott v. Commissioner, supra at 315. Petitioner failed to file any returns for the years 1973 through 1977 and failed to timely file his return for 1979. He argues that his failure to file returns in the years 1973 through 1977 was the result of advice he received from an unidentified person he consulted in 1973. Such erroneous advice does not constitute reasonable cause for his failure to comply with the statutory requirements. Even a good faith belief that one is not required to file a return does not constitute cause under section 6651(a)(1) unless bolstered by advice of a competent tax adviser who has been fully informed of all of the relevant facts. Stevens Bros. Foundation, Inc. v.

(footnote continued from previous page)
after a rather confusing interchange with the Court, appeared to concede that the stipulated amounts were accurate. Contrary to petitioner's statement, no adjustments in these amounts were made by the Court. Similarly, the Petition raises as an issue the business expense deductions allowed by respondent for 1978 and 1979. However, petitioner conceded that respondent had taken into account all expenses he could substantiate and, therefore, he was "not making an issue of additional expenses." As petitioner effectively conceded both issues, we need not address them.

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Commissioner, 39 T.C. 93, 133 (1962), affd. in part and revd. in part, 324 F.2d 633 (8th Cir. 1963).[23] See also United States v. Boyle, 469 U.S. ___, 105 S.Ct. 687 (1985). Petitioner offered no explanation for his failure to timely file a return for 1979. In view of the foregoing, we sustain respondent's determination of additions to tax pursuant to section 6651(a)(1).

Section 6653(a) imposes an addition to tax if any part of an underpayment of tax is due to negligence or intentional disregard of rules and regulations. Petitioner bears the burden of proving respondent's determination erroneous. Rule 142(a); Bixby v. Commissioner, 58 T.C. 757 (1972). Petitioner's failure to exercise due care in filing timely returns also gave rise to his failure to pay income taxes in the years 1973, 1974, 1976, 1977 and 1979. As to all years in issue, petitioner failed to present any evidence that his failure to pay or underpayment of tax was not due to negligence or an intentional disregard of rules and regulations. Consequently, he is liable for the additions to tax pursuant to section 6653(a) as determined by respondent.

Section 6654 imposes an addition to tax for any underpayment of estimated tax by an individual unless certain exceptions, none of which exists in the instant case, are applicable. The Court has held this addition to be mandatory if the tax has, in fact, been underpaid. The existence of extenuating circumstances is irrelevant. Mitchell v. Commissioner, 51 T.C. 641, 648 (1969), revd. 430 F.2d 1 (5th Cir. 1970), revd. 403 U.S. 190 (1971);

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[23] See also, Vinz v. Commissioner, T.C. Memo. 1984-84; Hoffman v. Commissioner, T.C. Memo. 1982-380.

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Estate of Ruben v. Commissioner, 33 T.C. 1071, 1072 (1960). Since there was in fact no payment, petitioner is liable for additions to tax pursuant to section 6654 as determined by respondent.

Decision will be entered under Rule 155.

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ORIGINAL

T. C. Memo. 1986-152

UNITED STATES TAX COURT

JAMES E. GRESEN, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 42442-84. Filed April 16, 1986.

James E. Gresen, pro se.

Mark D. Petersen, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

PANUTHOS, Special Trial Judge: This case was heard pursuant to section 7456(d) and Rules 180, 181, and 182.[1]

Respondent determined a deficiency of $2,955 in petitioner's 1981 Federal income tax.

[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated, and all Rule references are to the Tax Court Rules of Practice and Procedure.

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After concessions by the parties, the issues for decision are: (1) Whether petitioner had automobile expenses in an amount greater than those allowed by respondent; (2) whether respondent properly disallowed petitioner's claimed investment tax credit with respect to petitioner's automobile; and (3) whether respondent properly disallowed petitioner's home office expenses.

Petitioner resided in Milwaukee, Wisconsin, at the time he filed his petition. Some of the facts have been stipulated and are incorporated herein by reference.

During the taxable year, petitioner was an employee of WIZA Industries (WIZA). In addition, he was the sole proprietor of a business which he operated from his home. Petitioner sold precision measuring tools.

Petitioner claimed that, beginning in March 1981, he used his automobile for business purposes only, except for occasional trips to the store. On his return for 1981, petitioner claimed mileage expenses for trips which he made between WIZA and his residence. Petitioner claimed $2,360 in car and truck expenses.[2] In addition, he claimed depreciation of $2,048.66 on his automobile. Respondent, utilizing the standard mileage rate, allowed a deduction of $292 based upon a log maintained by petitioner. Respondent disallowed the entire amount of claimed depreciation.

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2 On his return for 1981, petitioner utilized the standard mileage rate to compute his car and truck expenses. At trial, however, he argued that he ought to be entitled to deduct his actual expenses for the car as well as depreciation.

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Automobile expenses are deductible if the automobile is used in connection with a trade or business; that portion of the use which is attributable to personal use is nondeductible. Sections 162(a) and 262. If the automobile expenses are deductible then there are two methods of computing the amount: the first is the actual method, whereby a taxpayer deducts actual expenses incurred as well as depreciation, if he chooses; and the second is the standard mileage rate method, whereby a taxpayer deducts car expenses computed by multiplying the number of business miles driven by standard mileage rates.[3]

The burden rests on petitioner to prove that he incurred deductible business expenses in connection with his automobile. Welch v. Helvering, 290 U.S. 111 (1933); Rule 142(a). Petitioner presented no evidence at trial, except his vague, confused, and uncorroborated testimony, to substantiate his claimed expenses of $2,360. Since petitioner failed to prove that respondent incorrectly utilized the standard mileage rate method, and he failed to prove his actual expenses, petitioner is not entitled to automobile expenses in excess of the $292 allowed by respondent. For the same reasons petitioner is not entitled to depreciation.

Petitioner also claimed an investment tax credit of $713.63 for the automobile; respondent disallowed this amount. Petitioner bought the automobile in August 1980. Respondent

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[3] See Rev. Proc. 82-61, 1982-2 C.B. 849.

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concedes that the automobile is section 38 property, which may otherwise have qualified for the investment tax credit. Nevertheless, respondent disallowed the investment tax credit claimed in 1981 because petitioner purchased the car in 1980 and placed it in service in 1980. Petitioner did not begin using his car in connection with his business until 1981. Since he placed the car in service in 1980 and utilized it for personal purposes, he is precluded from claiming an investment tax credit in 1981. Section 1.46-3(d)(4)(i), Income Tax Regs.[4]

Finally, petitioner deducted a total of $1,134.37 for home office expenses. Petitioner's gross income for the year from his business was $246.58. Respondent disallowed the entire amount of petitioner's home office deduction. Section 280A(c)(1)(A) allows a deduction for expenses allocable to a home office when the home office is used exclusively and on a regular basis as the taxpayer's principal place of business for any trade or business. Section 280A(c)(5) limits a taxpayer's deduction for home office expenses to the gross income derived from the business use of the home office minus the expenses allocable thereto which are allowable without regard to such business use. Respondent concedes that petitioner had a home office but disallowed the home office expense deduction because the expenses allowable without regard to business use exceeded petitioner's gross income derived from the home office. Since those expenses did in fact

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4 Solon v. Commissioner, T.C. Memo. 1980-77, affd. without published opinion 660 F.2d 496 (5th Cir. 1981).

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exceed petitioner's gross income derived from his home office, he is not entitled to any deduction under section 280A. Section 280A(c)(5); Scott v. Commissioner, 84 T.C. 683 (1985).[5]

Respondent is sustained on all issues, but due to concessions by the parties,

Decision will be entered under Rule 155.

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5 Sessions v. Commissioner, T.C. Memo. 1981-319.

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ORIGINAL

T. C. Memo. 1986-153

UNITED STATES TAX COURT

WILLIAM P. CHENG, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24207-82. Filed April 17, 1986.

Eugene D. Silverman and William W. Holcomb, for the petitioner.

John F. O'Brien, Willard J. Frank, and Robert B. Dugan, for the respondent.

MEMORANDUM OPINION

CLAPP, Judge: In a notice of deficiency, dated July 16, 1982, respondent determined deficiencies in petitioner's Federal income tax of $8,297 for 1977 and $22,679 for 1978.

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This case is before the Court on respondent's motion for partial summary judgment, and petitioner's cross-motion for partial summary judgment, each filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure. The issue raised in both motions is whether petitioner may deduct claimed losses for the taxable years in issue to the extent they resulted from alleged advanced minimum royalty payments.

Petitioner resided in San Diego, California at the time the petition was filed in this case.

The pleadings, affidavits and exhibits attached thereto contain the facts used for the purpose of ruling on the motions. The facts and inferences to be drawn therefrom must be viewed in the light most favorable to the party opposing the motion. Jacklin v. Commissioner, 79 T.C. 340, 344 (1982).[1]

Imperial Finance NV is a corporation formed in Netherlands Antilles which operated in Grand Cayman in the British West Indies. In 1977 Imperial Finance acquired an option to lease the mineral and mining rights on certain land in South West Africa. For each of the years 1977 and 1978 these rights were divided into one thousand "working interests" which were sublet to investors in full or fractional units. According to the sublease agreement, each working interest entitled the investor to mine and remove diamonds in return for a minimum annual royalty

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[1] Respondent states that, although it is his belief that the purported transactions did not, in fact, take place as described in the documents attached as exhibits, he concedes, for the purpose of his motion only, that they did take place as described.

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payment. The 1977 sublease provided for a five-year term which could be automatically extended from year to year upon payment of the minimum annual royalty until all the diamonds have been mined. The 1978 sublease called for a four-year term with the same provisions for extension.

The 1977 sublease agreement[2] contains the following provision with respect to the minimum annual royalty:

> 4. Minimum Annual Royalty. (a) Participant agrees to pay to Lessor a minimum annual royalty (the "Minimum Annual Royalty") of $150,000 per Lease Year regardless of the amount of diamonds, if any, which may actually be mined, removed or sold from the Property during such Lease Year. * * *
>
> (b) The Minimum Annual Royalties for the Lease Years ending on December 27, 1978, and thereafter are payable on or before the September 30th immediately preceding the commencement of each such Lease Year unless prior to June 30th immediately preceding the applicable September 30th of each Lease Year, the Participant notifies the Lessor that Participant does not intend to make such payment, in which event there will be a complete termination of all of Participant's rights hereunder except as hereinafter provided. Notwithstanding anything herein contained to the contrary, Lessor shall not exercise its right of foreclosure hereunder unless and until it has notified Participant and any assignee by 30-day written notice of Participant's failure to comply with the provisions hereof. Such notice shall state that Participant's failure to advise Lessor within 30 days of the date of such notice of Participant's intention not to continue to make the Minimum Annual Royalty Payment and Participant's further failure to make such payment shall result in Participant's total forfeiture of all rights granted hereunder.
>
> (c) References throughout this agreement to carats shall be to carats as they are mined-raw, rough and untreated.

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2 The 1978 sublease agreement contains substantially identical provisions except the date given in paragraph 4(b) is December 31, 1978 (sic?) instead of December 27, 1978.

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(d) For purposes of this Agreement, the following terms shall have the following meanings:

(1) The term "Minimum Yearly Carats" shall mean the first 1,200 carats which may be mined on behalf of Participant in each Lease Year.

(2) The term "Deficiency" shall mean the extent to which the number of carats mined on behalf of Participant in any Lease Year is less than the Minimum Yearly Carats.

(e) The Minimum Annual Royalties shall be subject to recoupment at the rate of $125 per carat on the Minimum Yearly Carats which are mined by or on behalf of Participant.

(f) In the event that a Participant subscribes for less than one undivided Working Interest, the term hereof shall be the same, but the Participant's right to withdraw from payment and further participation hereunder shall not commence until such time as the amount of cash paid by him as Minimum Annual Royalty Payments hereunder equals or exceeds $150,000.

The provisions dealing with remedies and forfeiture state in pertinent part as follows:

11. Remedies/Forfeiture. * * *

(b) Notwithstanding anything to the contrary contained herein, in the event Participant or any assignee has given notice of intent not to make payment of the Minimum Annual Royalty as provided in paragraph 4(b) hereof, then Participant shall not be liable therefor or for any future Minimum Annual Royalty, this Agreement shall terminate, and Participant will have no further rights hereunder except with respect to the cumulative Deficiency. Participant will be entitled to receive the cumulative Deficiency at such time that the Contract Miner (or its successor) mines such amount of carats for Participant under the Mining Agreement.

(c) Notwithstanding any other provisions of this Agreement, if Participant or any assignee fails to give the notice of intent stated in paragraph 4 (b) hereof, and fails to pay the Minimum Annual Royalty as provided in paragraphs 4 (a) and (b) hereof, then he shall suffer an absolute loss of any and all rights granted to Participant hereunder including but not limited to,

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> the aforementioned cumulative Deficiency, and neither party shall thereafter have any claim against the other.

In 1977 petitioner Cheng acquired a one-fifth fractional interest and paid $30,000 as an advance minimum royalty payment. He paid $6,000 directly and the remaining $24,000 was paid by the Bank of Nova Scotia, an independent financial institution pursuant to a nonrecourse obligation executed by petitioner. Petitioner did not elect to terminate his sublease at the end of the first year. Petitioner acquired an additional one-fifth fractional interest in 1978 and, therefore, paid $12,000 cash directly and paid the remaining $48,000 with funds provided by an independent financial institution. Petitioner continued to make annual payments through 1980 at which time he terminated his interest.

Each of the loans referred to above was evidenced by a promissory note and a lending agreement. The lending agreements for each year, although apparently executed by a different financial institution, were identical. They provided that the lender would, in addition to the 80 percent royalty paid in the first year, lend to the investor up to 80 percent of the royalty due in succeeding years to the extent that the diamonds recovered for the investor did not generate funds sufficient to cover the succeeding years' royalties and that the investor was not in default under the sublease. Interest was to accrue at the rate of ten percent per annum. The lending agreements provided that the principal of the loan was payable solely from the investor's

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share of proceeds of sales of diamonds. The promissory notes permitted certain penalties attributable to the contract miner to be applied to the interest on the notes. The notes stated that in the event any principal remained unpaid at the expiration of fifteen years from the date of the note, the remaining balance would be due and payable. The notes further stated in accordance with the lending agreement that the investor assigned to the lender as collateral all of the investor's rights under the investor's agreement with Imperial Finance, N.V. (the lessor), Universal Diamond Mining, N.V. (the contract miner) and Transworld Investors, Ltd. (the diamond sales company). Except for the aforementioned collateral, the lender was to be without recourse against the investor.

No diamonds were mined or sold in either 1977 or 1978.

Petitioner claimed on the Schedule C attached to his 1977 income tax return a $30,170 loss of which $30,000 represented his payment of the alleged minimum annual royalty. Petitioner claimed on the Schedule C attached to his 1978 income tax return a $60,340 loss of which $60,000 represented his payment of the alleged minimum annual royalty. In the notice of deficiency, respondent disallowed all the losses claimed with respect to the diamond mining venture. For purposes of these motions, we are concerned solely with the deduction for minimum annual royalties.

Rule 121(b) provides that a decision shall be rendered upon motion for summary judgment if it is shown that "there is no genuine issue as to any material fact and that a decision may be

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rendered as a matter of law." It further provides that "partial summary adjudication may be made which does not dispose of all the issues in the case."

Respondent contends that the alleged royalty payments are not deductible because they do not qualify as a minimum royalty as defined under section 1.612-3(b)(3), Income Tax Regs. In the alternative, respondent argues that at least eighty percent of the claimed royalty payments should be disallowed because the non-cash payments made by petitioner in the form of a nonrecourse note should be disregarded as a matter of law. The nonrecourse obligation, the payment of which was completely contingent upon the happening of future speculative events, should not be treated as bona fide debt for tax purposes.

Petitioner's cross-motion for partial summary judgment requests that the Court find as a matter of law that the deductions claimed for minimum royalty payments should be allowed (1) to the extent of the cash payment and (2) to the extent of any additional amounts determined at trial to constitute payment with monies borrowed from third parties.

The primary issue presented then is whether petitioner's royalty payments were paid pursuant to a minimum royalty provision as defined in section 1.612-3(b)(3), Income Tax Regs. If the payments were not made pursuant to a valid minimum royalty provision, then they are advanced royalties whose deductibility is limited to the extent of production and sale. It is agreed that there was no production or sale of diamonds during the years

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at issue. Therefore, in order for petitioner to be entitled to a royalty payment deduction, the payments must be made pursuant to a minimum royalty provision.

The relevant portion of the regulations provides:

> a minimum royalty provision requires that a substantially uniform amount of royalties be paid at least annually either over the life of the lease or for a period of at least 20 years, in the absence of mineral production requiring payment of aggregate royalties in a greater amount. For purposes of the preceding sentence, in the case of a lease which is subject to renewal or extension, the period for which it can be renewed or extended shall be treated as part of the term of the original lease. * * *

Thus, there must be a requirement that annual, uniform payments are made over a 20-year period or over the life of the lease.

Respondent argues that there is only an illusory obligation to pay minimum royalties because subsequent to the initial year, the lessee need not pay the minimum royalty so long as the lessee provides timely notification of intent not to pay. In respondent's view such an arrangement is not only at odds with the definition of a minimum royalty set forth in the regulation and as interpreted by this Court in Wing v. Commissioner, 81 T.C. 17 (1983), but also at odds with the purpose of a minimum royalty, i.e., economic incentive to the lessee to continuously develop and exploit the mineral lease.

Petitioner argues that neither Wing nor the regulation requires that the term of the lease be definite, only that the annual payments be uniform over the life of the lease. The life

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of the lease should be determined according to the facts as they actually occurred. Because petitioner continued to make payments for four years, the life of the lease was four years.

In Wing the agreement provided for payment by lessee of an "advanced minimum annual royalty of $60,000 ($6,000 for each of the first ten years of the sublease)." The agreement further provided that the minimum royalty would be paid $10,000 in cash and a nonrecourse note of $50,000. Under the note no payment was due until ten years after execution. This Court found that there was no requirement that the payment of $6,000 per year be made for the life of the lease. The taxpayer was only obligated to pay $10,000 in cash at first and possibly $50,000 at the end of the lease term. We stated:

> To qualify for the deduction, the petitioner must meet the terms of the regulation, which sets out that a minimum royalty provision must require payment at least annually. That the note may in fact be paid at some later date is not sufficient to establish the existence of such a requirement. [81 T.C. at 40-41. Emphasis in original.]

It is true that the regulations do not speak to the necessary length of the lease. We agree with respondent, however, that the regulation does not contemplate a case-by-case determination as to the term of the lease based on petitioner's unfettered discretion. The lease contract states that the term is for five years with possible extensions. Petitioner asks us to ignore the term of the lease as stated in the contract and instead look at the facts presented in each case to determine the

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life of the lease based on petitioner's own unilateral conduct. It is clear, however, from the lease that there is no requirement that payments be made after the initial year.

Petitioner argues that Wing is distinguishable from the present case because here there are four annual uniform payments rather than a lump-sum payment. Also, the nonrecourse notes were not given to the lessor but rather to an independent third party lender. In Wing there was no economic incentive to develop or exploit the mineral lease because no cash, only a nonrecourse note due in 10 years, was available to pay for such activities. Here, however, petitioner argues that such an incentive existed because the loan proceeds were paid to the lessor and were available for the development of mineral production. However, petitioner ignores the fact that after the first year there was no guarantee that any more proceeds would be paid and made available.

Petitioner relies on footnote 33 in Wing which states:

> 33. We note that if the agreement had a provision stating only that royalties would be paid $6,000 per year for the life of the lease, then each year the lessee is forced to pay or else face forfeiture of the mineral interest security. In the present case, there is no such requirement, at least until the year 1987.

Petitioner argues that if he exercised his right to terminate at the end of the year, he would forfeit his rights to participate in future profits of the venture. Because of this potential

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forfeiture, petitioner is in essentially the same position as a taxpayer who is obligated to make minimum royalty payments under a lease with a definite term.

This Court in the footnote was only noting that there was no annual requirement in the royalty provision at issue there. We concluded in Wing that there must be an enforceable requirement that substantially uniform minimum royalties be paid annually. Here, petitioner's ability to withdraw from the lease at will "belies any actual requirement to make annual royalty payments." Capek v. Commmissioner, 86 T.C. 14, 47 (1986). Also, we note that petitioner is incorrect that the lessee forfeits his rights to share in future mining under paragraph 11(b) of the sublease. The lessee is entitled to receive the cumulative deficiency. While petitioner by not paying the next year's royalty would forfeit his rights to future profits in the venture beyond the cumulative deficiency, he would receive, if petitioner's theory is adopted, a present benefit in the form of a tax deduction of $5 for every $1 of his own cash invested. The 80 percent of the royalties borrowed from the lender only had to be paid from the sales proceeds of the diamonds, if any.

In sum, because there is no enforceable requirement that annual payments be made over the life of the lease, the lease does not satisfy the minimum annual royalty provision requirement. Therefore, petitioner is not entitled to deduct the royalties.

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Accordingly, respondent's motion for partial summary judgment is granted and petitioner's motion is denied.

An appropriate order will be issued.

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742-B COMPLETED Jul 11. 7/2 : 1986-154

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T. C. Memo. 1986-154

UNITED STATES TAX COURT

NORMAN J. and ANNIE G. FREDKIN, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 9187-81. Filed April 17, 1986.

Shlomo Aaron Beilis and Donald Jay Pols, for the petitioners.

John F. O'Brien and Robert B. Dugan, for the respondent.

MEMORANDUM OPINION

CLAPP, Judge: In a notice of deficiency, dated March 20, 1981, respondent determined deficiencies in petitioners' Federal income tax of $19,336 for 1977 and $15,881 for 1978.

This case is before the Court on respondent's motion for partial summary judgment filed pursuant to Rule 121, Tax Court Rules of Practice and Procedure. The issue raised is whether

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petitioners may deduct claimed losses for the taxable years in issue to the extent they resulted from alleged advanced minimum royalty payments.

Petitioners resided in Massachusetts at the time their petition was filed in this case.

The pleadings, affidavits and exhibits attached thereto contain the facts used for the purpose of ruling on the motions. The facts and inferences to be drawn therefrom must be viewed in the light most favorable to the party opposing the motion. Jacklin v. Commissioner, 79 T.C. 340, 344 (1982).[1]

Imperial Finance NV is a corporation formed in Netherlands Antilles which operated in Grand Cayman in the British West Indies. Imperial Finance acquired an option to lease the mineral and mining rights on certain land in South West Africa. These rights were divided into one thousand "working interests" which were sublet to investors in full or fractional units. According to the sublease agreement, each working interest entitled the investor to mine and remove diamonds in return for a minimum annual royalty payment. Paragraph three of the 1977 sublease agreement provided as follows:

> 3. Term. Unless sooner terminated in the manner herein provided, the term hereof shall be for a period of five (5) years commencing on December 28, 1977, and terminating on December 27, 1982, and subject to the terms hereof, including, but not limited to, the Participant fulfilling all of Participant's obligations hereunder, may be automatically extended from year to year upon the Participant continuing to make payment of

[1] With the exception of the amounts invested, the factual pattern in this case is identical to that in Cheng v. Commissioner, T.C. Memo. 1986-153, filed on this date.

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> the Minimum Annual Royalty (as hereinafter defined) when due until all of the mineable and merchantable diamonds have been mined and removed from the granted Property. * * *

The 1978 sublease called for a four-year term with the same provisions for extension.

The 1977 sublease agreement[2] contains the following provision with respect to the minimum annual royalty:

> 4. Minimum Annual Royalty. (a) Participant agrees to pay to Lessor a minimum annual royalty (the "Minimum Annual Royalty") of $150,000 per Lease Year regardless of the amount of diamonds, if any, which may actually be mined, removed or sold from the Property during such Lease Year. * * *
>
> (b) The Minimum Annual Royalties for the Lease Years ending on December 27, 1978, and thereafter are payable on or before the September 30th immediately preceding the commencement of each such Lease Year unless prior to June 30th immediately preceding the applicable September 30th of each Lease Year, the Participant notifies the Lessor that Participant does not intend to make such payment, in which event there will be a complete termination of all of Participant's rights hereunder except as hereinafter provided. Notwithstanding anything herein contained to the contrary, Lessor shall not exercise its right of foreclosure hereunder unless and until it has notified Participant and any assignee by 30-day written notice of Participant's failure to comply with the provisions hereof. Such notice shall state that Participant's failure to advise Lessor within 30 days of the date of such notice of Participant's intention not to continue to make the Minimum Annual Royalty Payment and Participant's further failure to make such payment shall result in Participant's total forfeiture of all rights granted hereunder.
>
> (c) References throughout this agreement to carats shall be to carats as they are mined-raw, rough and untreated.
>
> (d) For purposes of this Agreement, the following terms shall have the following meanings:

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2 The 1978 sublease agreement contains substantially identical provisions except the date given in paragraph 4(b) is December 31, 1978 (sic?) instead of December 27, 1978.

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(1) The term "Minimum Yearly Carats" shall mean the first 1,200 carats which may be mined on behalf of Participant in each Lease Year.

(2) The term "Deficiency" shall mean the extent to which the number of carats mined on behalf of Participant in any Lease Year is less than the Minimum Yearly Carats.

(e) The Minimum Annual Royalties shall be subject to recoupment at the rate of $125 per carat on the Minimum Yearly Carats which are mined by or on behalf of Participant.

(f) In the event that a Participant subscribes for less than one undivided Working Interest, the term hereof shall be the same, but the Participant's right to withdraw from payment and further participation hereunder shall not commence until such time as the amount of cash paid by him as Minimum Annual Royalty Payments hereunder equals or exceeds $150,000.

The provisions dealing with remedies and forfeiture state in pertinent part as follows:

11. Remedies/Forfeiture. * * *

(b) Notwithstanding anything to the contrary contained herein, in the event Participant or any assignee has given notice of intent not to make payment of the Minimum Annual Royalty as provided in paragraph 4(b) hereof, then Participant shall not be liable therefor or for any future Minimum Annual Royalty, this Agreement shall terminate, and Participant will have no further rights hereunder except with respect to the cumulative Deficiency. Participant will be entitled to receive the cumulative Deficiency at such time that the Contract Miner (or its successor) mines such amount of carats for Participant under the Mining Agreement.

(c) Notwithstanding any other provisions of this Agreement, if Participant or any assignee fails to give the notice of intent stated in paragraph 4 (b) hereof, and fails to pay the Minimum Annual Royalty as provided in paragraphs 4 (a) and (b) hereof, then he shall suffer an absolute loss of any and all rights granted to Participant hereunder including but not limited to, the aforementioned cumulative Deficiency, and neither party shall thereafter have any claim against the other.

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In 1977 petitioner Norman Fredkin (hereinafter petitioner in the singular) acquired a one-third fractional interest and paid $50,000 as an advance royalty payment. He paid $10,000 directly and the remaining $40,000 was paid by First Fidelity Bonding Co., Ltd. an unrelated party, pursuant to a nonrecourse obligation executed by petitioner. Petitioner did not elect to terminate his sublease at the end of the first year. Petitioner paid $50,000 in 1978 in the same manner.

The loan referred to above was evidenced by a promissory note and a lending agreement. The lending agreement provided that the lender would, in addition to the 80 percent royalty paid in the first year, lend to the investor up to 80 percent of the royalty due in succeeding years to the extent that the diamonds recovered for the investor did not generate funds sufficient to cover the succeeding years' royalties and that the investor was not in default under the sublease. Interest was to accrue at the rate of ten percent per annum. The lending agreement provided that the principal of the loan was payable solely from the investor's share of proceeds of sales of diamonds. The promissory note permitted certain penalties attributable to the contract miner to be applied to the interest on the note. The note stated that in the event any principal remained unpaid at the expiration of fifteen years from the date of the note, the remaining balance would be due and payable. The note further stated in accordance with the lending agreement that the investor assigned to the lender as collateral all of the investor's rights

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under the investor's agreement with Imperial Finance, N.V. (the lessor), Universal Diamond Mining, N.V. (the contract miner) and Transworld Investors, Ltd. (the diamond sales company). Except for the aforementioned collateral, the lender was to be without recourse against the investor.

No diamonds were mined or sold in either 1977 or 1978.

For each of the years 1977 and 1978, petitioners claimed on the Schedule C attached to their return a $50,170 loss of which $50,000 represented payment of the alleged minimum annual royalty. In the notice of deficiency, respondent disallowed all the losses claimed with respect to the diamond mining venture. For purposes of this motion for partial summary judgment, we are concerned solely with the deduction for minimum annual royalties.

Rule 121(b) provides that a decision shall be rendered upon motion for summary judgment if it is shown that "there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." It further provides that "partial summary adjudication may be made which does not dispose of all the issues in the case."

Respondent contends that the alleged royalty payments are not deductible because they do not qualify as a minimum royalty as defined under section 1.612-3(b)(3), Income Tax Regs. In the alternative, respondent argues that at least eighty percent of the claimed royalty payments should be disallowed because the non-cash payments made by petitioner in the form of a nonrecourse note should be disregarded as a matter of law. The nonrecourse

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obligation, the payment of which was completely contingent upon the happening of future speculative events, should not be treated as bona fide debt for tax purposes.

Petitioners contend that the royalty payments were paid pursuant to a minimum annual royalty provision. In the alternative, petitioners contend that the payments are deductible as rent or delay rentals.

The initial issue presented is whether petitioners' royalty payments were paid pursuant to a minimum royalty provision as defined in section 1.612-3(b)(3), Income Tax Regs. This issue has been dealt with in Cheng v. Commissioner, T.C. Memo. 1986-153 filed on this date, to which reference is made.

Initially, petitioners herein argued that the term of the lease was unclear. On the one hand, paragraph three provided that it was a five year lease with the option to renew on a year-to-year basis. On the other hand, the parties might have intended a year-to-year lease renewable by payment of a minimum annual royalty. Petitioners in their reply brief, however, claim that the lease is for at least a five year term and because of the option to renew is of unlimited duration. Petitioners then state that the annually recurring payments are required for the entire lease term. Petitioners claim that the obligation to make these payments is not illusory relying on United States v. Swank, 451 U.S. 571 (1981), which held that a lessee had an economic interest in minerals in place despite a provision in the lease

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allowing either party (or the lessor alone) to terminate the lease with 30 days notice. Petitioners argue that the same reasoning should apply to a royalty deduction.

We believe that United States v. Swank, supra, has no applicability to the case at bar inasmuch as it involves a question of economic interest and the percentage depletion deduction. The Court reasoned that there was no rational basis for linking such a deduction to any particular length of time. The allowability of the advance royalty deduction pursuant to a minimum royalty provision where there is no production is, however, linked to a period of time, i.e. the payments must be made over the life of the lease or for a period of at least 20 years.

Based on the foregoing, we conclude that because there is no enforceable requirement that annual payments be made over the life of the lease, the lease does not satisfy the minimum annual royalty provision requirement. Therefore, petitioner is not entitled to deduct the royalties.

Petitioners argue, in the alternative, that if the payments are not royalties then they should be considered as rent or delay rentals. Petitioners argue that under South West African law Nambia Diamond Mining Company from whom Imperial Finance acquired the option possessed only a prospecting grant not a mining grant. Such prospecting grant cannot be leased without approval from the government. Therefore, petitioners could not have acquired an economic interest but only a contract right.

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We agree with respondent that there is no basis to the claim that these payments are rent or delay rentals. The sublease agreement which is entitled "Sublease Agreement for Diamond Mining Purposes" specifically confers the rights to mine and remove diamonds. The agreement only refers to royalties--it does not intimate in any way that a tenant relationship is intended. The payments at issue here were made pursuant to paragraph four of the sublease which only refers to royalties. If in fact the lessor did not possess the right to mine and could not lease out any rights it did have, it does not follow that the investors are, therefore, entitled to a tax deduction. Rather, it undermines the entire agreement upon which the deductions at issue are based.

Accordingly, respondent's motion for partial summary judgment is granted.

An appropriate order will be issued.

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T. C. Memo. 1986-155

UNITED STATES TAX COURT

ROBERT W. LEWIS and REBECCA H. LEWIS, ET AL.,[1] Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 28924-84, 19383-85, 19384-85, 19386-85. Filed April 17, 1986.

David S. Elkouri, for the petitioners.

David G. Hendricks, for the respondent.

MEMORANDUM OPINION

WILLIAMS, Judge: In these consolidated cases the Commissioner determined deficiencies in petitioners' Federal income taxes in the following amounts:

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1 Cases of the following petitioners are consolidated herewith: Michael C. Kirk and Julia T. Kirk, docket No. 19383-85; James P. Kirk and Elizabeth H. Kirk, docket No. 19384-85; J. Philip Kirk, Jr. and Judy Kirk, docket No. 19386-85.

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Docket No.	Petitioner	Taxable Year 1978	1979	1980
28924-84	Robert W. and Rebecca H. Lewis	$10,139.00	$3,437.00	$2,767.00
19383-85	Michael C. and Julia T. Kirk	872.00	492.00	424.00
19384-85	James P. and Elizabeth H. Kirk	3,799.00	2,003.00	1,482.00
19386-85	J. Philip Jr. and Judy Kirk	797.00	430.00	261.00

After concessions, the sole issue for decision is whether section 212[2] entitles petitioners to deduct a distributive share of a limited partnership's ordinary and necessary pre-operating expenses incurred during the years 1978 and 1979.

The facts of these cases have been fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure, and are so found. Petitioners resided at the addresses indicated below at the time their petitions were filed:

Docket No.	Petitioner	Address
28924-84	Robert W. and Rebecca H. Lewis	Larned, Kansas
19383-85	Michael C. and Julia T. Kirk	Kansas City, Missouri
19384-85	James P. and Elizabeth H. Kirk	Fairway, Kansas
19386-85	J. Philip, Jr. and Judy Kirk	Kansas City, Kansas

Casper Hotel Associates (CHA) is a Kansas limited partnership formed on September 29, 1977 to build, own and operate a 238 room Hilton Hotel in Casper, Wyoming. CHA's general partners are Transamerica Investment Properties (TIP), a Kansas corporation, and TIP-Casper, Ltd. (TCL), a Kansas limited partnership whose general partners are TIP and David H. Aull.

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2 All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

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Thirty-three units of the CHA partnership were offered and sold at a price of $50,500.00 per unit beginning December 27, 1977. Each unit represented a 2.9997% interest in the partnership. The offering was closed and petitioners' subscriptions were accepted on February 23, 1978.

Petitioners Robert W. and Rebecca H. Lewis purchased one unit of the CHA partnership for $50,500.00 in 1978. Petitioners Michael C. and Julia T. Kirk purchased 1/6 unit of the CHA partnership for $8,416.67 in 1978. Petitioners James P. and Elizabeth H. Kirk purchased 1/2 unit of the CHA partnership for $29,250.00 in 1978. Lastly, petitioners J. Philip, Jr. and Judy Kirk purchased 1/6 unit of the CHA partnership for $8,416.67 in 1977.

CHA filed Federal partnership information returns on the cash method of accounting for the years 1978, 1979 and 1980, on which it claimed losses for those years in the amounts of $670,421.00, $681,350.00 and $354,885.00, respectively. Respondent disallowed $453,372.00, $229,125.00 and $171,167.00 of the losses for the years 1978, 1979 and 1980, respectively. Petitioners' distributive shares of the CHA partnership losses claimed by them on their Federal income tax returns for those years were accordingly disallowed by respondent.

After adjustments agreed to by the parties, the disallowed costs remaining in dispute are included in the following expenses claimed by the partnership: start-up costs of $255,920.00 and $49,567.00 expensed respectively in the years 1978 and 1979, and

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the amortization of certain other start-up costs in 1978, 1979 and 1980 of $4,177.00, $27,225.00 and $27,225.00, respectively. The start-up costs expensed by CHA in the years 1978 and 1979 were all incurred in 1978. The parties agree that these costs are ordinary and necessary expenses and that they consist of the following non-capital items and amounts:

Item	Year Paid 1978	Year Paid 1979	Total
Payroll	$121,561.00	$ -0-	$121,561.00
Travel	4,321.00	9,702.00	14,023.00
Telephone	4,463.00	696.00	5,159.00
Equipment Rent	1,256.00	4,130.00	5,386.00
Dues/Subscriptions	638.00	-0-	638.00
Advertising	846.00	-0-	846.00
Repairs/Maintenance	596.00	-0-	596.00
Utilities	7,543.00	15,623.00	23,166.00
Legal/Accounting	23,166.00	-0-	23,166.00
Insurance	3,825.00	-0-	3,825.00
Miscellaneous	2,297.00	8,620.00	10,917.00
Management Fees	75,000.00	-0-	75,000.00
Reservation Expenses	569.00	-0-	569.00
Automobile Expenses	-0-	628.00	628.00
Data Processing	-0-	345.00	345.00
Pre-Opening Expenses	-0-	426.00	426.00
FICA	7,596.00	-0-	7,596.00
State Unemployment Tax	2,243.00	2,491.00	4,734.00
Workman's Compensation	-0-	6,278.00	6,278.00
Federal Unemployment Tax	-0-	628.00	628.00
Total	$255,920.00	$49,567.00	$305,487.00

Of these costs, the parties agree that $67,917.13 and $7,100.00 are deductible in 1978 and 1979, respectively, as ordinary and necessary business expenses deductible under section 162, incurred after CHA commenced being in the trade or business of operating a hotel. Further, the parties agree that the legal and

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accounting costs of $23,166.00 listed above are organization costs within the meaning of section 709 to be amortized over a period of 60 months.

The start-up costs amortized in 1978, 1979 and 1980 are based on a 36-month amortization of $75,623.99 and $6,050.00 expended by the CHA partnership in 1978 and 1979, respectively. These costs are stipulated to be ordinary and necessary, and consist of the following items and amounts:

Item	Year Paid 1978	1979
Kitchen Supplies	$ 377.65	$ -0-
Bar Supplies	865.69	-0-
Food Supplies	8,837.36	-0-
Maintenance Supplies	2,463.53	-0-
Office Supplies	3,225.64	-0-
Housekeeping Supplies	9,203.27	-0-
Banquet Supplies	1,374.48	-0-
Pool Supplies	170.03	-0-
Trash Removal	3,297.24	-0-
Storage and Delivery	1,205.94	-0-
Smoking Urns, First-Aid Kit, Time Card Rack	8,409.43	-0-
Basic Bed DXL	672.35	-0-
Plates	144.38	-0-
Chalkboards (4)	422.48	-0-
Key Blanks	1,071.72	-0-
Tray	264.15	-0-
Advertising Expenses	14,805.74	-0-
Recruitment Expenses	7,331.12	-0-
Freight Expenses	588.10	-0-
Grand Opening Expense	948.77	-0-
Contract Cleaning Expenses	515.00	-0-
Legal Expenses	2.00	-0-
Phone Installation Expenses	4,842.97	-0-
Desk - Delivery	124.80	-0-
Promotion Expense	426.02	-0-
Installation Wages	1,378.00	-0-
Other	2,656.13	-0-
Miscellaneous Equipment	$ -0-	$6,050.00
Total	75,623.99	$6,050.00

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Of these costs, the parties agree that a total of $39,689.56 for the years 1978 and 1979 is not at issue in these cases. The parties agree that all start-up costs and amortized expenditures above which are remaining at issue are non-capital expenditures.

All expenses at issue were incurred subsequent to the acquisition by CHA of title to the property and subsequent to petitioners' acquisition of their respective partnership interests. CHA acquired title to the land on which the hotel was constructed in December of 1977. Construction of the hotel was financed by a loan of $5,825,000.00 from the First National Bank of Denver, and construction commenced in October of 1977. CHA obtained a permanent mortgage loan in the amount of $5,500,000.00 through the Equitable Life Assurance Society; the commitment fee for this loan was $55,000.00, which respondent has conceded to be deductible in 1978. CHA commenced being in the trade or business of operating a hotel on November 15, 1978.

Petitioners contend that their distributive shares of the ordinary and necessary expenses incurred by CHA in 1978 prior to its being in the trade or business of operating a hotel are deductible under section 212. Respondent argues that

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the expenses incurred are preopening or start-up expenditures which are not deductible as current expenses under section 162 or section 212.

The parties agree that the expenses at issue in this case are ordinary and necessary expenses which would qualify as deductible business expenses under section 162 except that the partnership was not carrying on a trade or business when the expenses were incurred. There is no dispute that petitioners have a proprietary interest in the income-producing property. Further, the parties agree that the expenses at issue were incurred in connection with an income producing activity. The sole point of controversy is whether section 212 permits the expenses at issue to be deducted because they were incurred prior to the commencement of the income producing activity.[3]

Pursuant to section 212 an individual may deduct ordinary and necessary expenses incurred during the taxable year for the production of income or for the management, conservation or maintenance of property held for the production of income. An

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[3] SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

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expense incurred to produce income or to manage, conserve or maintain income producing property is deductible whether the expense is incurred in connection with income produced in the year the expense is incurred or in earlier or subsequent years. Section 1.212-1(b), Income Tax Regs. While section 212 generally provides the same restrictions and limitations on deductibility of expenses as provided by section 162, the two sections are not identical; an important exception that is critical to the resolution of these cases is that section 212 does not require the expenses to have been incurred in connection with the carrying on of a trade or business. H. Rept. No. 2333, 77th Cong., 2d Sess. 75 (1942); Trust of Bingham v. Commissioner, 325 U.S. 365, 373-374 (1945) (discussing the predecessors of sections 162 and 212).

Because section 212 lacks the trade or business requirement of section 162, if an expense is incurred to manage, conserve or maintain income producing property, the income producing activity need not have commenced prior to permitting related expenses to be deducted. Section 1.212-1(b), Income Tax Regs.; Hoopengarner v. Commissioner, 80 T.C. 538, 541 (1983), affd. without published opinion 745 F.2d 66 (9th Cir. 1984). In Hoopengarner, the taxpayer acquired a leasehold interest in land; the lease required the taxpayer to develop the leased premises. The Court determined that the taxpayer was not in a trade or business during the taxable year in which he sought to deduct rental payments made under the lease and characterized the rent, 80 T.C.

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at 540, as preoperating expenses which are not deductible under section 162. Richmond Television Corporation v. United States, 345 F.2d 901, 907 (4th Cir. 1965). The Court went on to hold, however, that the leasehold interest was property held for the production of future income for purposes of section 212(2). Since section 212 has no "trade or business" requirement prohibiting the deduction under section 162 of expenses incurred prior to the commencement of a trade or business, the Court held that such preoperating expenses were deductible. 80 T.C. at 543.

Our holding in Hoopengarner was followed by this Court in Johnsen v. Commissioner, 83 T.C. 103 (1984). In Johnsen, the taxpayers were partners in a limited partnership formed to develop real estate who sought to deduct their distributive share of the commitment, management and guarantee fees incurred by the limited partnership. The Court found that the expenses were incurred before the partnership had commenced being in a trade or business, but noted that in Hoopengarner "[w]e concluded that the preopening expense doctrine, concerning expenses prior to the commencement of a trade or business, did not apply to section 212 since such section had no trade or business requirement." 83 T.C. at 118. The Court followed Hoopengarner and ruled that

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the taxpayers were entitled to deduct their distributive share of the preoperating expenses at issue which were incurred by the limited partnership.[4] 83 T.C. at 126.

Hoopengarner and Johnsen control these cases. The expenses at issue here are ordinary and necessary to the management, conservation and maintenance of petitioners' income producing property. The expenses were incurred with respect to property in which the taxpayer had a proprietary interest. Although paid prior to the year in which income was realized from the property, under respondent's own regulation expenses incurred in connection with income to be realized in subsequent taxable years are deductible in the year the expenses are paid. Section 1.212-1(b), Income Tax Regs.

CHA was formed to build, own and operate a Hilton Hotel in Casper, Wyoming and commenced being in the trade or business of operating the hotel in November of 1978. We find accordingly that the preoperating expenses at issue in these cases were incurred with respect to property held for the production of future income within the meaning of section 212.[5] Petitioners

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[4] The Court in Johnsen upheld respondent's determination that a portion of the permanent loan commitment fee should be disallowed, on the grounds that that portion was not an ordinary and necessary expense. 83 T.C. at 124-125. In these cases respondent conceded the deductibility of the permanent loan commitment fee.

[5] A partnership is not allowed the deduction under section 212 in computing its taxable income. Section 703(a)(2)(E); section (footnote continued)

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are therefore entitled to deduct, pursuant to section 212, their distributive shares of such ordinary and necessary preoperating expenses. Hoopengarner v. Commissioner, supra, and Johnsen v. Commissioner, supra.

Respondent argues, however, that our decisions in Hoopengarner and Johnsen are inconsistent with Congressional intent and should be overruled. Respondent contends that the enactment of section 195 implies that preoperating expenses were never intended to be deductible under section 212.

Effective for taxable years ending after July 29, 1980, section 195 was enacted to allow an individual taxpayer an election to treat "start-up expenditures" incurred or paid in connection with investigating or creating an active trade or business as deferred expenses amortizable over a minimum of 60 months. Section 195 was amended in 1984, effective for taxable years beginning after June 30, 1984, to provide that no deduction would be allowed for start-up expenditures except as provided under that section. Such expenses thus may not be deducted pursuant to section 212 in taxable years commencing after June 30, 1984. Respondent contends on this basis that Congress has declared that Hoopengarner and Johnsen are inconsistent with its intended statutory scheme.

(footnote continued from previous page)
1.703-1(a)(2)(vi), Income Tax Regs. However, each partner may take into account his distributive share of the partnership's losses under section 212 in computing his own taxable income. Section 702(a)(7); section 1.702-1(a)(8)(i), Income Tax Regs.

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First, as the Supreme Court has stated so well, "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." United States v. Price, 361 U.S. 304, 313 (1960); see also Rainwater v. United States, 356 U.S. 590, 593 (1958). Second, respondent's argument misses the mark by a considerable distance. Congress did not overrule Hoopengarner retroactively or even from the date of enactment of section 195 but chose to overrule it effective for taxable years commencing after June 30, 1984. Third, an act of Congress is generally to be applied prospectively from its effective date. United States v. Estate of Donnelly, 397 U.S. 286 (1970). We decline to extend section 195, as amended and in effect in 1984, to taxable years prior to its Congressionally mandated effective date. Similarly, we decline to infer from the actions of a later Congress that preoperating or start-up expenses for the taxable years at issue in this case were intended to be excluded from the scope of section 212 by the earlier Congress which enacted the original provision.[6]

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In its report on the 1984 amendments to section 195, the Senate Finance Committee did not spurn Hoopengarner v. Commissioner, 80 T.C. 538 (1983) affd. without published opinion 745 F.2d 66 (9th Cir. 1984), as a distortion of section 212. The committee report notes simply that the existing law on the deductibility of preopening expenses pursuant to section 212 and section 195 was unclear and that respondent disagreed with this Court's holding in Hoopengarner. S. Rept. 98-169, 282 (1984).

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We note the Eighth Circuit's contrary views as stated in Aboussie v. United States, 779 F.2d 424, 428 n.6 (8th Cir. 1985), but, for the reasons set forth above, we will continue to follow Hoopengarner. Because of the Golsen doctrine, Golsen v. Commissioner, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), we will apply the Eighth Circuit's views to docket number 19383-85 because venue on appeal in that docket lies with the Eighth Circuit. As to all other dockets consolidated herein, which are appealable to the Tenth Circuit, we will follow Hoopengarner.

To reflect concessions by the parties,

Decisions will be entered pursuant to Rule 155.

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T. C. Memo. 1986-156

UNITED STATES TAX COURT

HERMAN SIMON AND URSULA SIMON, ET AL.,[1] Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket Nos. 10911-77, 10940-77, 8908-80, 8909-80, 8910-80, 8911-80, 8912-80, 15423-80, 15627-80, 19078-80, 21030-80, 1485-81.

Filed April 21, 1986.

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[1] Cases of the following petitioners are consolidated herewith: Isidore Feldman and Rose Feldman, docket No. 10940-77; Nathan Henin and Florence Henin, docket No. 8908-80; Leonard Harris and Minnie Harris, docket No. 8909-80; Peter Feldman and Susan Feldman, docket No. 8910-80; Jerome Harris and Anne Harris, 8911-80; Isidore Feldman and Rose Feldman, docket No. 8912-80; Herman Simon and Ursula Simon, docket No. 15423-80; Consolidated Lumber Corporation, docket No. 15627-80; National Industries of Lexington, Inc., docket No. 19078-80; Marilyn Togs, Inc., docket No. 21030-80; Jack Pearlstein and Thelma Pearlstein, docket No. 1485-81.

Guy Fairstein and Burton C. Agata, for the petitioners.

Theodore Kletnick, Jo-Ann Fox, and Patricia Donahue, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

HAMBLEN, Judge: In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes and additions to the tax as follows:

Docket No.	Petitioners[2]	Taxable Year Ending	Deficiency	Addition to tax Sec. 6653(a)[3]
10911-77	H. Simon	12/31/73	$4,239.81[4]	$211.99
		12/31/74	582.39	29.12
10940-77	I. Feldman	12/31/73	29,451.00[5]	1,472.55
		12/31/74	4,090.94	204.55

2 Ursula Simon, Rose Feldman, Florence Henin, Minnie Harris, Susan Feldman, Anne Harris, and Thelma Pearlstein are parties to this action only by virtue of filing joint Federal income tax returns with their husbands. Therefore, unless otherwise specified, petitioner or petitioners shall refer to petitioner husbands only.

3 Unless otherwise specified, all section references are to the Internal Revenue Code of 1954, as amended and in effect during the taxable years at issue. All rule references are to the Tax Court Rules of Practice and Procedure.

4 Partnership losses in the amount of $50,298.80 from Tennessee Coal Associates, a limited partnership, were subsequently claimed by the Simons as a net operating loss carryback from 1976. The losses were attributable to the investment of Isidore Feldman and Company.

5 Partnership losses in the amount of $272,052.00 from Tennessee Coal Associates, a limited partnership, were subsequently claimed by the Feldmans as a net operating loss carryback from 1976. The losses were attributable to the investment of Isidore Feldman and Company.

8908-80	N. Henin	12/31/76	304,108.00
8909-80	L. Harris	12/31/76	317,581.00
8910-80	P. Feldman	12/31/76	50,837.00
8911-80	J. Harris	12/31/76	254,017.00
8912-80	I. Feldman	12/31/76	126,154.70
15423-80	H. Simon	12/31/76	59,695.00
15627-80	Consolidated Lumber Corp.	3/31/77	384,431.00
19078-80	National Industries of Lexington, Inc.	6/30/77	456,133.92
21030-80	Marilyn Togs, Inc.	8/31/77	449,590.00
1485-81	J. Pearlstein	12/31/76	360,862.00

After concessions the issue for decision[6] is the amount, if any, that petitioners as partners may deduct as their distributive share of losses attributable to Tennessee Coal Associates.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

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6 In the case of Herman and Ursula Simon, docket No. 15423-80, there is an additional issue relating to deductions for medical expenses under sec. 213. The amount available will be determined arithmetically based on our decision as to the deductibility of partnership losses.

Petitioners Herman Simon and Ursula Simon resided in Bergenfield, New Jersey, when they filed their petitions in this case. Petitioners Isidore Feldman and Rose Feldman resided in Kings Point, New York, when they filed their petitions in this case. Petitioners Nathan Henin and Florence Henin resided in West Lebanon, New Hampshire, when they filed their petition in this case. Petitioners Leonard Harris and Minnie Harris resided in Cedarhurst, New York, when they filed their petition in this case. Petitioners Peter Feldman and Susan Feldman resided in Kings Point, New York, when they filed their petition in this case. Petitioners Jerome Harris and Anne Harris resided in Cedarhurst, New York, when they filed their petition in this case. Petitioner Consolidated Lumber Corporation was a corporation with its principal place of business at Clifton, New Jersey, when its petition was filed in this case. Petitioner National Industries of Lexington, Inc., was a corporation with its principal place of business at Lexington, North Carolina, when its petition was filed in this case. Petitioner Marilyn Togs, Inc., was a corporation with its principal place of business at New York, New York, when its petition was filed in this case. Petitioners Jack Pearlstein and Thelma Pearlstein resided in Boca Raton, Florida, when they filed their petition in this case.

Tennessee Coal Associates ("TCA") is a limited partnership formed by Fannie Jacobs as the general partner and her son Robert Jacobs as the limited partner. TCA was formed to "deal in and

own interests in coal producing properties and leases." The Certificate of Limited Partnership for TCA was dated June 29, 1976. However, the certificate stated that the partnership term commenced on January 2, 1976.

TCA reported its income on the accrual basis for Federal income tax purposes. All of the individual petitioners reported their income on the cash basis. Isidore Feldman and Company also reported its income on the cash basis. The corporate petitioners reported their income on the accrual basis.

In the spring of 1976 Robert Jacobs began discussing the possibility of investment in a coal venture with petitioner Peter Feldman ("Peter") and Peter's partner, petitioner Herman Simon ("Herman"). Coal prices were on an upward trend in 1976, and coal was increasingly attractive as an energy source after the 1973 oil embargo. Robert Jacobs told Peter of the favorable prospects of coal investment, and Peter subsequently discussed the investment with his father, petitioner Isidore Feldman ("Isidore"). However, the investment discussions did not proceed any further at that time.

In June of 1976 Robert Jacobs again approached Peter regarding the possibility of investment in a coal venture, and Peter discussed the investment with Herman and Isidore. Jacobs proposed that Peter come into TCA. Discussions regarding the investment continued through the summer, and Isidore began approaching other potential investors. Some of the potential investors whom Isidore approached and who ultimately became

partners in TCA were clients of Isidore Feldman and Company, an accounting firm in which Isidore and Herman were partners. The firm prepared Federal income tax returns for these clients. Clients of Isidore Feldman and Company had invested in other projects undertaken by Peter.

By letters addressed to Peter and dated September 23, 1976, and October 7, 1976, individual petitioners Nathan Henin, Leonard Harris, Jerome Harris and Jack Pearlstein each agreed to "contribute $150,000 as [his] participation in Tennessee Coal Associates." Corporate petitioners Marilyn Togs, Inc., Consolidated Lumber Corporation and National Industries of Lexington, Inc. adopted resolutions reflected in corporate minutes dated September 7, 1976, September 9, 1976, and September 28, 1976, respectively, each authorizing an investment of $250,000 in TCA or in a coal partnership in which Peter was general partner.

TCA entered into a coal sublease with Irving H. Kanarek and Alan S. Jacobs, a Partnership, ("K & J") by lease agreement dated October 27, 1976.[7] The agreement was signed by Fannie Jacobs as general partner of TCA and by her son Alan Jacobs for K & J. The sublease was recorded on December 29, 1976. Accompanying the sublease was a metes and bounds description of the property

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7 As the date of execution of the agreement does not affect the conclusion we reach in these cases, we accept the date shown on the document. Nevertheless, strong proof was introduced by respondent which tends to show that there was backdating by some unknown element of the transactional parties.

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subject to the sublease ("Area 5").[8] A memorandum of lease was executed on December 14, 1976, in the name of Peter as general partner of TCA by William Z. Bergenfield as his attorney-in-fact. The memorandum of lease was recorded on December 30, 1976.

Irving H. Kanarek was a certified public accountant who practiced in a partnership with Robert Jacobs. Their office was located at the same address as Isidore Feldman and Company. Alan Jacobs was a partner in a law firm with Herman and Eli Uncyk and had offices at the same address as Isidore Feldman and Company. Alan Jacobs and Robert Jacobs were brothers.

Area 5 was approximately 900 acres of a 6,000 acre tract ("Lacy Tract"). K & J executed other coal subleases relating to the Lacy Tract with at least seven other partnerships. Five of the other coal subleases were dated October 27, 1976, and signed for the lessee partnership by Fannie Jacobs as general partner. A memorandum of lease was executed for each sublease between December 14, 1976, and December 28, 1976. The memoranda of lease were recorded between December 29, 1976, and December 31, 1976. Subdivision of the Lacy Tract reduced its mining potential.

8

Respondent maintains that the metes and bounds description was prepared subsequent to October 27, 1976. John G. Donan, Jr., of Donan Engineering, Inc. testified that he was requested to subdivide and prepare a metes and bounds description of the 6,000 acre tract which included Area 5 on November 10, 1976. We are impelled to state, in this respect, that we found Mr. Donan to be a highly credible witness and that petitioners failed in their endeavor to impeach his testimony.

The coal sublease executed by K & J and TCA provided that TCA as lessee would have the exclusive right to "mine and remove the coal on and in connection with the Premises" subject to enumerated limitations in the sublease and those in the underlying leases. The term of the sublease was for ten years or the exhaustion of the merchantable and mineable coal, whichever was longer. The sublease further provided that "[a]fter the lessee has completed strip mining the surface of any tract on the Premises, the surface of such tract shall cease to be subject to this lease."

Royalty payments were in the amount of a minimum annual royalty of $1,000 and a per ton royalty of $3.00 per short ton plus 25 percent of the sales price above $20.00 per short ton of steam coal or $28.00 per short ton of metallurgical coal removed, shipped or sold. In addition an advanced royalty in the amount of $6,000,000 was to be paid to K & J prior to December 31, 1976. Payment of the $6,000,000 was to be made in cash of $1,000,000 and a nonrecourse, promissory note of $5,000,000.[9] The advanced royalty was to be recouped at the rate of $2.50 per ton for each short ton of coal removed, shipped or sold. The advanced royalty

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9 Ultimately, TCA made a cash payment of $925,000 on December 31, 1976. With the cash payment TCA delivered promissory notes of Grady-White Boats, Inc., a subsidiary of National Industries of Lexington, Inc., and Marilyn Togs, Inc. The promissory notes were in the total amount of $400,000 and were accompanied by letters of credit. In addition TCA delivered a nonrecourse note in the amount of $4,675,000.

was not payable until a satisfactory current title report was obtained. On forfeiture of the sublease by TCA there was no provision for abatement of any portion of the advanced royalty.

Prior to 1930 the Lacy Tract had been mined by the Durham Coal and Iron Company and the Fox Coal Company. At least four underground mines were opened by the two companies. No recorded mining activity occurred on the Lacy Tract between 1930 and 1970.

Testing indicated that coal removed from the Lacy Tract could not be marketed other than locally. The coal would require cleaning or washing in order to be readily marketable. There was no washing facility in the immediate vicinity of the Lacy Tract although a washing facility did exist approximately 10 miles away in Dayton, Tennessee. There was transportation available to the washing facility and to potential markets for the coal.

The Lacy Tract was located in Hamilton, Rhea and Bledsoe Counties in southeastern Tennessee. Area 5 was located in Hamilton and Rhea Counties and bordered Bledsoe County. This is an area of erratic coal seams. Erratic coal seams increase the cost of mining and require more extensive investigation before the decision to mine is made. The total coal production for the three counties for the 10 year period between 1967 and 1976 as shown by the Annual Production Report of Mines prepared by the Department of Labor of the State of Tennessee was 997,874 tons.

On October 28, 1971, Southeast Coal, Oil and Gas Co, Inc. ("Southeast") entered into a lease agreement, as lessee, with L and G Corporation, Boone Development Co., Steve Lacy, M. S.

Lacy, and Wayne Graybeal, as lessors, with respect to the right to mine and remove coal on the Lacy Tract. John Wolcott signed the agreement as president of Southeast. The minimum period of the lease was 15 years. John Wolcott was a shareholder of Southeast. Under the lease Southeast was to pay a royalty of $.25 per short ton of all coal removed, shipped or sold from underground mining and a royalty of $.35 per short ton for all coal removed, shipped or sold from augering or stripping methods. In addition Southeast was to pay a minimum annual royalty of $60,000 in the first year and an amount not less than $60,000 in succeeding years if no mining was done on the property. The lease also gave Southeast the option to purchase the interests of the lessor in the property for a total consideration of $565,000.00. Southeast made some preparations to mine, including building a tipple. Southeast did locate a contract miner who produced approximately 10,000 tons through strip mining but who later abandoned mining on the property. Southeast was unable to locate another contract miner and did not do any other mining on the property.

Southeast entered into a coal sublease of the Lacy Tract with K & J, as lessee, by lease agreement dated October 27, 1976. The minimum period of the sublease was 10 years. Under the sublease K & J was to pay any royalties due under the underlying lease. In addition K & J was to pay $.10 per short ton of all coal removed, shipped or sold. K & J was also to pay an advanced royalty of $1,500,000 prior to December 31, 1976. Payment of the

$1,500,000 was to be made in cash of $750,000 and a nonrecourse promissory note of $750,000. The advanced royalty was to be recouped at the rate of $.10 per short ton of coal removed, shipped or sold. The agreement was signed by John Wolcott as president of Southeast and Alan Jacobs as a partner of K & J. The coal sublease agreement between Southeast and K & J was recorded on December 29, 1976.

Peter and the limited partners who are petitioners in this action did not become formally associated with TCA until December of 1976. On December 28, 1976, and December 30, 1976, amendments to the Certificate of Limited Partnership of TCA were executed, substituting Peter for Fannie Jacobs as general partner and providing for the admission of additional limited partners. Robert Jacobs, the original limited partner, continued to have an interest as a limited partner. Robert Jacob's total investment in TCA was $100 although he retained a one percent interest in TCA. In the original Federal income tax return filed by TCA, the loss attributable to this interest was $59,000.

In December of 1976 an undated private placement memorandum with respect to the TCA offering was prepared but not filed with the New York State Attorney General's Office. K & J and its partners were designated as promoters. The private placement memorandum provided, in part:

> No agreement has been entered into with respect to mining the Partnership Coal Property. However, the General Partner has discussed such proposed agreement with the companies that furnish coal mining services. It is intended that the Partnership will enter into an Agreement * * * with such a company * * *, which may be Southeast Coal, Oil & Gas Co., Inc. * * * However, there

can be no assurance that the Mining Contract will be entered into on the proposed terms. Moreover, in the event the Mining Contract is entered into, there can be no assurance that the Contract Miner will be able to continue to mine the Partnership Coal Property on the basis proposed should the costs of mining increase or the price at which the Partnership coal is sold decrease.

* * *

Although the attractiveness of this investment is, to a considerable extent, based upon anticipated benefits currently available under the present provisions of the Internal Revenue Code of 1954, as amended, and the regulations promulgated thereunder, there is no assurance that such laws and regulations will not be changed, and there is no assurance that the anticipated tax benefits will be available to the Limited Partners. * * *

* * *

Recently, the Service has proposed a revision of its applicable regulation (Treasury Regulations Section 1.612-3(b)) with the effect of imposing severe restrictions on the deductibility for Federal income tax purposes of advance royalty payments similar to the Advance Royalty which the Partnership contemplates paying. Based upon the facts recited to it and the documents which it has reviewed, counsel to the Partnership is of the opinion that the transaction which is the subject of this Memorandum is not affected by this proposal; however, there can be no assurance that the Service will not disagree with this conclusion or question the deductibility of the Advance Royalty on any other grounds.

Each of the petitioners other than Peter signed a subscription agreement relating to the TCA offering.[10] In part, each subscriber warranted:

4. He has read and is familiar with the Private Placement Memorandum ("the Memorandum") of the Partnership * * *

5. He has consulted with his professional, tax, and legal advisors with respect to the Federal and state or local income tax consequences of his participation as a Limited Partner of the Partnership and with respect to his investment in the Units.

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10 Isidore and Herman signed as partners in Isidore Feldman and Company.

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The subscription agreements were signed between December 27, 1976, and December 31, 1976.

Petitioners made payments for their limited partnership interests by checks dated between December 14, 1976, and December 31, 1976. Checks dated prior to December 29, 1976, were made payable to "Isidore Feldman as Attorney." In addition Marilyn Togs, Inc. and Grady White Boats, Inc., a subsidiary of National Industries of Lexington, Inc., each delivered notes in the amount of $200,000 collateralized by an irrevocable letter of credit.

On December 29, 1976, and December 31, 1976, checks in the total amount of $1,100,000 were delivered to TCA. Of this amount $912,500 was by check payable from Isidore representing amounts he had received from other investors made payable to him as attorney-in-fact. In addition the notes from Marilyn Togs, Inc. and Grady-White Boats, Inc. were delivered to TCA on December 31, 1976.

TCA delivered a check to K & J in the amount of $925,000 on December 31, 1976. TCA also delivered to K & J the notes from Marilyn Togs, Inc. and Grady-White Boats, Inc. and a nonrecourse note payable by TCA in the amount of $4,675,000. The note provided for interest on the outstanding balance to commence accruing on June 1, 1977, at six percent per annum. Interest and principal were to be paid in equal monthly installments of $51,902.08 beginning on June 30, 1977. The principal amount was to be prepaid to the extent that TCA mined and sold more than

17,301 tons of coal in any month. The note was secured by "a security interest in and general lien upon the Leasehold Property and the proceeds derived from the use and exploitation thereof." The above-described consideration was in lieu of the consideration described in the lease agreement between TCA and K & J dated October 27, 1976. After the payment to K & J and payments for management and legal fees, TCA retained cash in the total amount of $101,000. TCA had no other assets except a receivable in the amount of $100.

As part of the coal sublease transaction between TCA and K & J, K & J entered into an agreement dated December 31, 1976, with Isidore Feldman and Company. The agreement provided that Isidore Feldman and Company would receive $300,000 and 20 percent of any amounts collected on the TCA note. These payments were to compensate Isidore Feldman and Company for its services in connection with the coal sublease between TCA and K & J. The only services Isidore Feldman and Company performed was as finder. The fact of this payment was disclosed to the limited partners of TCA.

Peter did not anticipate that TCA would perform any mining activities. In fact, initial mining activities were undertaken by Raybled Mining Company ("Raybled") organized by John Wolcott, Irving Kanarek and Alan Jacobs. Raybled was organized as part of the coal sublease between Southeast and K & J and was to be funded by K & J. Raybled commenced mining activities in the spring of 1977. The agreement between Raybled and TCA was never

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reduced to writing. Raybled subsequently contracted with Hensley & Schmidt, a local engineering company, to do on-site mining. Hensley & Schmidt had little experience in coal mining.

Peter did not have any experience in developing coal or other mineral properties prior to October of 1976. Peter did not retain an independent mining consultant or financial analyst to advise him or TCA on or before October 27, 1976. Instead Peter relied on the advice of Robert Jacobs. There was information available in 1976 which indicated that there were potentially recoverable coal reserves in the vicinity of Area 5.

After October 27, 1976, Peter did prepare his own projections for TCA. These projections were based on information from Robert Jacobs and from a report dated November 9, 1976, prepared by John G. Donan, Jr., of Donan Engineering, Inc. for John Wolcott of Southeast ("Donan Report"). The underlying assumptions used in the Donan Report were clearly stated and included the following:

2. I assume no responsibility for matters legal in nature nor do I render any opinion as to the title or the lease which is assumed to permit the recovery of the coal.

3. It was not within the scope of this study to evaluate the mining plans to recover the coal seams and it was assumed that the coal can be mined by present mining methods and practices. * * *

4. The plats, legal descriptions, map, drill hole data, seam thickness, outcrop elevations, and other reports furnished to me were assumed to be correct.

The Donan Report did not contain any estimate of costs associated with mining recoverable coal.

In early 1977 Peter began looking for a mining consultant to represent him independently. The mining consultant whom he chose was Ford, Bacon & Davis, ("FBD"). FBD submitted its proposal to study Area 5 for TCA on April 22, 1977. This proposal stated in pertinent part:

Scope of Work

This study will cover the following:

1. Review of existing data pertaining to the coal resources and their possibilities for commercial development and exploitation. This review will reveal the data that may be lacking for planning of the mine, etc.

2. Systematic procurement of pertinent data that may be lacking. (Aerial photography of Area 5 at scale 1" = 200 feet would be in this category of data to be procured).

3. Preliminary technical and economic feasibility studies of the potential for mine development of:

   a. Area 5 as a segment of the overall mine development of Areas 1 through 6.

   b. Area 5 as an independent mine development project.

4. Study of potential markets for coal produced from Area 5.

5. Preliminary determination of the optimum rate of coal production from Area 5.

6. Preliminary development of methods of mining at select rates of coal production of Area 5 including the optimum as determined above in paragraph 4.

7. [sic] This study will include both underground and surface mining methods.

8. Preliminary determination of the capital costs of mine development, mine equipment, coal transportation equipment, and related facilities needed for developing Area 5.

9. Preliminary determination of the operating costs of mining of Area 5 at select rates of production level.

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10. The preparation of a preliminary cash flow statement for facilities and operations for Area 5 operated as an independent mine operation at select rates of production level.

Peter and FBD agreed that the work performed by FBD would be narrower in scope than the work proposed as there was already an engineering consultant involved in the project. FBD agreed to act only as an advisor and a consultant through Myles Walsh, a mining consultant employed by FBD.

TCA did not successfully develop an economically viable mining operation at Area 5. On June 27, 1977, FBD advised Peter that available information was inadequate to evaluate the feasibility of underground mining and that surface mining should be explored. Strip mining, however, was not attempted because Hiwassee Land Company, an unrelated party, owned a portion of the surface rights on Area 5. Raybled and Hensley & Schmidt continued to proceed to develop underground mining through 1977. However, after this operation resulted in a Cease Order issued by the State of Tennessee, Peter with the assistance of FBD began directing mining operations.

Peter organized Deep Down Mining, Ltd., to replace Raybled as the contract miner for TCA in late 1977. In June of 1978 Tennessee Partners, Ltd., acquired the stock of Deep Down Mining, Ltd., and mined 10,000 tons of coal. Tennessee Partners, Ltd., made royalty payments to TCA, and TCA used the royalty amounts received to pay the interest on the nonrecourse obligation to

K & J. K & J subsequently paid the amounts received from TCA to Tennessee Partners, Ltd. FBD made periodic progress reports related to the mining activities of Tennessee Partners, Ltd., which concluded that the economics of mining Area 5 were in doubt. Tennessee Partners, Ltd., subsequently ceased operations, and no further mining was attempted.

OPINION

Each of the petitioners in this consolidated case was a partner in TCA on December 31, 1976.[11] The issue in this case is whether petitioners may deduct their allocable share of partnership losses claimed by TCA in its taxable year ending December 31, 1976. The partnership losses are attributable to accrued expenses deducted by TCA for management fees, advanced royalties and legal fees. In his notices of deficiency, respondent disallowed the deductions attributable to TCA which were claimed by petitioners. Respondent maintains that the losses claimed on petitioners' Federal income tax returns for the years at issue and the additional losses claimed by petitioners in their petitions and amended petitions are not allowable because the partnership activity was not engaged in with the objective of making a profit. In the alternative, respondent argues that the advanced royalty payment is deductible only to the extent the coal was sold, that the nonrecourse note delivered

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11 Isidore and Herman were partners in Isidore Feldman and Company which was a partner in TCA.

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to K & J as part of the advanced royalty payment lacked economic substance, and that the amount of cash and recourse notes representing the balance of the royalty payment must be capitalized and amortized over the term of the sublease.

The threshhold question is whether TCA's activities were engaged in with the objective of making a profit. Each of the expenses claimed by TCA must satisfy the requirements of section 162(a) or section 212(1) or (2).[12] In order to satisfy the requirements of these provisions the activity must be engaged in with "an actual and honest objective of making a profit." Capek v. Commissioner, 86 T.C. 14, 36 (1986). A reasonable expectation of profit is not required, but the taxpayer's profit objective must be bona fide. Surloff v. Commissioner, 81 T.C. 210, 233 (1983); Fox v. Commissioner, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. without published opinion sub nom. Hook v. Commissioner, Kratsa v. Commissioner, Leffel v. Commissioner, Rosenblatt v. Commissioner, Zemel v. Commissioner, 734 F.2d 5-7, 9 (3d. Cir. 1984), affd. sub nom. Barnard v. Commissioner, 731 F.2d 230 (4th Cir. 1984). "Profit" means economic profit without consideration of tax savings. Capek v. Commissioner, supra at 36; Surloff v. Commissioner, supra at 233. If the activity is not engaged in with the requisite objective of making a profit, the deductions

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12 While the sums expended for the legal fees might have been deductible in whole or in part under sec. 212(3), petitioners presented no evidence that those expenditures were related to tax advice.

are only allowable to the extent that gross income derived from the activity exceeds deductions allowable irrespective of whether the activity is engaged in for profit. Sec. 183(b)(2).

Where the activities are conducted by a partnership, the profit objective must be present at the partnership level. Fox v. Commissioner, supra at 1006; Brannen v. Commissioner, 78 T.C. 471, 505 (1982), affd. 722 F.2d 695 (11th Cir. 1984). However, since a partnership is merely a formal entity, a determination of profit objective can be made by reference to the activities of the individuals who manage the partnership. Rosenfeld v. Commissioner, 82 T.C. 105, 112-113 (1984); Fox v. Commissioner, supra at 1007-1008. These individuals need not be partners. Fox v. Commissioner, supra at 1008.

The issue of whether the partnership has the requisite profit objective is one of fact which is to be resolved by examination of the surrounding facts and circumstances. Capek v. Commissioner, supra at 37; Hager v. Commissioner, 76 T.C. 759, 784 (1981). In making this determination, the Court will give greater weight to objective facts than mere statements of intent. Surloff v. Commissioner, supra at 233. The burden of proof is on petitioners to show the existence of a profit objective. Rule 142(a).

Here, during the partnership taxable year ending December 31, 1976, the record clearly indicates that none of the partners of TCA, with the exception of Robert Jacobs, took an active role in managing the partnership or developing mining

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operations. There is no evidence that Fannie Jacobs, the original general partner of TCA, was ever active in the management of TCA. Peter, who succeeded Fannie Jacobs and formally became the general partner of TCA on December 28, 1976, did not retain an independent mining consultant or financial analyst to advise him on or before October 27, 1976, nor does the record indicate that he retained an independent advisor at any other time prior to the date when he contacted FBD in the spring of 1977. Instead Peter acquiesced in the decisions made by Robert Jacobs and John Wolcott, Irving Kanarek and Alan Jacobs through Raybled. While Peter did prepare projections for TCA, the underlying data for these projections was supplied by Robert Jacobs and John Wolcott.

As the record indicates that Robert Jacobs, John Wolcott, Alan Jacobs and Irving Kanarek actively managed TCA during its taxable year ended December 31, 1976, it is their actions which are determinative of a profit objective at the partnership level. Initially, we note that all of these individuals would benefit directly or indirectly from the transactions which ultimately resulted in the sale of Area 5 to TCA irrespective of TCA's ability to profitably mine coal and pay its nonrecourse obligation to K & J. John Wolcott, a shareholder in Southeast, would be benefitted by the cash payment to Southeast by K & J for advanced royalties and payments on the underlying lease. The total cash amount paid was $750,000, presumably one-sixth or $125,000 was allocable to Area 5. Alan Jacobs and Irving Kanarek as partners in K & J received from TCA $900,000 in cash and

recourse notes after the payment to Southeast attributable to Area 5 and the payment of $300,000 to Isidore Feldman and Company. The $900,000 amount would be reduced by payments in the underlying lease. The $900,000 amount would be further reduced by any amounts used to capitalize Raybled. However, there is no evidence as to what amount, if any, Raybled received from K & J. Although the record does not disclose that Robert Jacobs received any cash payments either individually or through an entity in which he had an interest, it is not unlikely that he benefitted indirectly from the payments made to K & J in which his brother, Alan Jacobs, and his partner, Irving Kanarek, were partners. In addition the transactions with TCA resulted in a partnership loss of $59,000 reported on the original TCA Federal income tax return for 1976 attributable to the limited partnership interest of Robert Jacobs on an investment of $100.

The actions of Robert Jacobs, John Wolcott, Alan Jacobs and, Irving Kanarek convince us that their primary objective and consequently, that of TCA for whom they were acting was to recognize the above described benefits rather than to engage in a profit making coal venture. While coal investment in general may have been attractive to investors seeking economic benefits, they marketed this venture on the basis of expected tax benefits. By utilizing an accrual basis partnership they could offer most of the investors who were cash basis taxpayers benefits which could not be recognized as individual investors. In order to find suitable investors they paid Isidore Feldman and Company a

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$300,000 finder's fee.[13] If the expected tax benefits were recognized, Robert Jacobs, John Wolcott, Alan Jacobs and Irving Kanarek and the investors would reap substantial benefits without any activity on the part of TCA. Fortuitously, the transactions involving TCA were purportedly consummated on October 27, 1976, two days prior to the effective date of section 1.612-3(b)(3), Income Tax Regs., which would have precluded a deduction for the $6,000,000 amount characterized as an advanced royalty.[14]

Although petitioners claim that TCA did have a profit objective, this contention is not supported by the record. With the exception of John Wolcott, none of the individuals who had substantial involvement in structuring the transactions or operating TCA during 1976 testified at the trial of this case, and we may infer that their testimony would not support petitioners' claim that the coal transactions were engaged in with a profit objective.[15] Wichita Terminal Elevator Co. v.

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13 Isidore Feldman and Company invested $187,500 of this fee in TCA.

14 See notes 7 and 8, supra.

15 Petitioners argue that such an adverse inference is not appropriate citing N.L.R.B. v. Chester Valley, Inc., 652 F.2d 263, 271 (2d Cir. 1981). However, as petitioners clearly have the burden of proof as to TCA's profit objective, their reliance on N.L.R.B. v. Chester Valley, Inc., supra, is misplaced.

Peter and Isidore who had minimal involvement in these transactions in 1976 did testify. We found Peter's testimony to (footnote continued)

Commissioner, 6 T.C. 1158, 1165 (1946), affd. 162 F.2d 513 (10th Cir. 1947). John Wolcott did not provide any specific testimony relating to profit objective.

In addition to the facts and circumstances surrounding the marketing of TCA and the failure of petitioners to adduce any testimony as to profit objective from the individuals who structured and conducted the transactions, there are numerous other factors which support our conclusion that TCA did not have the requisite profit objective. First, the $6,000,000 amount characterized as an advanced royalty was grossly disproportionate to any royalties previously paid for the same property. Southeast which had acquired a coal lease on the entire Lacy Tract in 1971 was to make minimum annual royalty payments of $60,000 the first year and not less than $60,000 in succeeding years if no mining was done. The rateable share of this payment allocable to Area 5 would presumably be one-sixth or $10,000 per year. K & J, which purportedly acquired a coal sublease from Southeast for the entire Lacy Tract on the same date as it entered into the coal sublease with TCA, agreed to pay an advanced royalty of $1,500,000. The rateable share of the

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(footnote continued from previous page)
be mostly self serving. His testimony is entitled to little weight in view of his pecuniary interest in the outcome of these cases, and the same is true for Isidore, Peter's father, whose firm benefitted from the transactions with the investors to the tune of $300,000 and from losses claimed as a result of its partnership interest. Peter's case is further weakened by the absence of testimony of the transactional parties such as the Jacobs who made a substantial profit from the arrangements.

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payment allocable to Area 5 would presumably be one-sixth or $250,000. Even assuming that the marketability of coal increased dramatically between the date of the Southeast lease and October 27, 1976, justifying an increase in the royalties paid, petitioners have offered no credible explanation as to why TCA would agree on the same date of the Southeast sublease to K & J to pay an advanced royalty of 24 times the amount paid by K & J.[16]

Second, the evaluation of the mining potential of Area 5 was totally inadequate to justify a binding commitment to pay an advanced royalty in the amount of $6,000,000. It is undisputed that there were coal resources on Area 5 and that this fact was known in 1976. However, whether recovery of this coal was economically feasible was not established in 1976. Although the Donan Report which was prepared after the TCA coal sublease was purportedly executed indicated that Area 5 could be mined, it was clear on the face of this report that no reliance could be placed on the report to determine whether it was feasible to mine the coal on Area 5 as "it was assumed [for the report] that the coal can be mined by present mining methods and practices." Petitioners' own expert testified that he would have advised petitioners to enter into an option agreement on the basis of this report to permit completion of evaluation of the property.

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16 In this respect it is petitioners who assert that the K & J sublease and the TCA sublease were executed on the same date.

In addition, although Robert Jacobs supplied information to Peter relating to profit potential, there is no evidence that Robert Jacobs' information was anything more than conjecture. Further, it is clear from the proposal submitted by FBD on April 22, 1977, that the information relating to development of mining on Area 5 was not sufficient as of that date to permit an evaluation of the economic viability of mining on Area 5. Finally, Area 5 was located in a region with erratic coal seams which would increase the cost of mining and require more extensive investigation before a decision to mine was made.

The only substantial mining which had taken place on the Lacy Tract had occurred nearly 50 years prior to 1976. On the date that the coal sublease between K & J and TCA was purportedly executed, John Wolcott was aware that recent strip mining efforts had been abandoned on the Lacy Tract after a relatively insubstantial amount of coal had been mined. John Wolcott also knew that no other contract miner had been located to mine the property. Although he testified at the trial of this case, John Wolcott did not offer any explanation as to why recent mining efforts had been abandoned and nc other contract miners had been located to mine the property. Certainly the information known to John Wolcott did not suggest that the Lacy Tract could be successfully mined.

In addition there was other information available to the parties that indicated that the coal operation contemplated on Area 5 should be carefully evaluated before any commitment was

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made. The Annual Production Report of Mines prepared by the Department of Labor of the State of Tennessee shows that total coal production for the years 1967 through 1976 for Bledsoe, Hamilton and Rhea Counties was 997,874 tons. The coal production required on Area 5 to recoup the $6,000,000 amount paid to K & J characterized as an advanced royalty for the ten year minimum sublease period was 2,400,000 tons of coal, almost two and one-half times the amount of production in the three counties in which Area 5 was located or adjacent to for the preceeding ten year period. The information relating to production in Bledsoe, Hamilton and Rhea Counties would be pertinent to any decision to mine Area 5. However, there is no evidence in the record that this fact was a consideration in evaluating the potential for development of Area 5.

Third, even had the parties actively managing TCA adequately evaluated the existence of mineable coal on Area 5, the manner in which they structured the coal sublease to TCA and conducted mining operations virtually assured failure by TCA. The Lacy Tract was divided into subdivisions rather than mined as a contiguous tract. Mining the property as separate subdivisions reduced the mining potential of the entire tract.

TCA itself was not adequately capitalized to conduct underground mining operations. After the payments to K & J and payments for management and legal fees, TCA only retained $101,000 in cash for operations. Peter testified that Robert Jacobs had promised to supply $1,000,000 to a contract miner in

order to mine the property. However, no binding commitment to mine the property had been executed in December of 1976 when the prospectus was prepared. Although Raybled ultimately became the contract miner for TCA, no agreement was ever executed. There is no evidence that Raybled was ever capitalized to the extent promised by Robert Jacobs or made expenditures approximating the $1,000,000 amount in relationship to the development of mining operations at Area 5. In fact, experts for both respondent and petitioner indicated that the contract miner did not have adequate capital to conduct mining operations contemplated at Area 5.[17]

The coal sublease executed by TCA and K & J provided that the amount characterized as advanced royalty was not payable until a satisfactory current title report was obtained. However, it is clear that such a title report was never prepared. Although the sublease provided that TCA would have strip mining rights, strip mining was precluded because the surface rights were not acquired by TCA. There is no indication that any of the parties who structured the coal sublease between K & J and TCA were aware of the ownership of the surface rights, and it is inconceivable that they could have obtained a satisfactory title report without being apprised of the ownership of the surface rights.

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17 See Surloff v. Commissioner, 81 T.C. 210, 234-235 (1983), involving a similar situation.

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TCA was not managed by people with coal mining experience. There is no evidence that the individuals who actively managed TCA and were to develop mining operations had any expertise in coal mining operations. Although John Wolcott claimed that he was a businessman who had engaged in the coal business, the record does not indicate that he was ever actively involved in day-to-day coal operations. In fact John Wolcott was unable to provide any specific testimony relating to his coal mining experience. Despite John Wolcott's apparent lack of experience in day-to-day coal operations, he was to conduct the mining operations for TCA through Raybled. Hensley & Schmidt, the local engineering company which was selected by Raybled to do on-site mining, had little experience in coal mining. In fact, Peter endeavored to become active in the management and development of coal mining operations in the years subsequent to 1976 because mining development had not been properly conducted.[18]

On the basis of this record we find that TCA's coal mining activities were not engaged in with the objective of making a profit. Instead TCA was organized and operated in 1976 in order to provide cash from the investors for John Wolcott, Irving

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Most of Peter's post 1976 activities seem to be hindsight to extricate himself (and his father's firm) from a disenchanting situation for the investors and to shore up the tax benefits which were claimed as a result of the transactions. Apparently, Peter was assisted in these activities by Irving Kanarek and Alan Jacobs who, through K & J, acted as a conduit to return royalty payments purportedly made by Tennessee Partners, Ltd., the contract miner engaged by Peter, to Tennessee Partners, Ltd.

Kanarek, Alan Jacobs and Robert Jacobs and tax benefits for the investors. Accordingly, we must deny petitioners' claimed loss deductions attributable to TCA. Having determined that TCA did not have the requisite profit objective, we decline to consider respondent's alternative arguments.

To reflect the foregoing,

Decision will be entered for the respondent in docket Nos. 8908-80, 8909-80, 8910-80, 8911-80, 8912-80, 15423-80, 15627-80, 19078-80, 21030-80, and 1485-81.

Decision will be entered under Rule 155 in docket Nos. 10911-77 and 10940-77.

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UNITED STATES TAX COURT

JOHN L. KNESS AND MARY KNESS, Petitioners v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 24167-84. Filed April 21, 1986.

Richard D. Clark, for the petitioners.

Allan E. Lang, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: During the course of the examination of their Federal income tax returns for 1978 and 1979, petitioners paid certain deficiencies in income tax. Subsequently, respondent determined that petitioners are liable for the following additions to tax:

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Year	Addition to Tax Sec. 6653(b), I.R.C. 1954	Sec. 6653(a), I.R.C. 1954
1978	$ 9,260	$-0-
1979	$31,333	$-0-
1980	$ -0-	$552

Petitioners concede that they are liable for the section 6653(a)[1] addition to tax for 1980. The only issue for decision is whether they are liable for the section 6653(b) additions to tax and that depends on whether any part of their underpayments of tax for 1978 and 1979 was due to fraud within the meaning of section 6653(b).

FINDINGS OF FACT

At the time they filed their petition, petitioners were legal residents of Loveland, Colorado. They filed joint Federal income tax returns for 1978 and 1979 with the Internal Revenue Service Center, Ogden, Utah.

During 1978 and 1979 and for a number of years previously, petitioners were engaged in the business of farming and cattle feeding. To finance their business, they maintained a line of credit with Mountain Plains Production Credit Association (hereinafter PCA). In making cattle purchases they drew on their PCA account, and the net proceeds of all of their cattle sales were credited directly on that account. All of the cattle purchases and sales material to this case (including the ones relevant to

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[1] All section references are to the Internal Revenue Code of 1954, as amended, unless otherwise noted.

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the fraud issue) are reflected as disbursements and repayments on PCA ledger statements.

Petitioners' cattle purchases during 1978 and 1979 were made through Farmers Cattle Company and their sales were made through Farmers Livestock Commission Company. Shortly after cattle were purchased, petitioners received a purchase invoice from Farmers Cattle Company reflecting the purchase. After cattle were sold, petitioners received a sales statement from Farmers Livestock Commission Company. The proceeds of sales were turned over to PCA, and it sent petitioners a statement reflecting the application of the receipts to petitioners' loan account.

Petitioners' record of their farming and cattle-feeding operations for 1978 and 1979 was maintained in a Farm Book based on a simplified single entry bookkeeping system. Petitioner Mary Kness (hereinafter Mrs. Kness) was responsible for posting entries in the Farm Book and keeping other records of the farming and cattle-feeding operations.

Under the method of bookkeeping used by petitioners, cattle sales reflected on the sales statements received from Farmers Livestock Commission Company were posted to the "Cattle Sales" page under the sales column in petitioners' Farm Book. Invoices for petitioners' cattle purchases from the Farmers Cattle Company were accumulated and, when the cattle were sold, were posted to the "Cattle Sales" page under the cost column in the Farm Book. Receipts mailed or given to petitioners by PCA covering the

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proceeds of cattle sales were posted to "Loan Repayments" in petitioners' Farm Book.

The parties stipulated that, on or about the following dates during 1978 and 1979, petitioners made the following cattle sales:

1978

Date	Head of Cattle Sold	Amount
1/ 4/78	240	[1]$126,021.12
5/ 4/78	199	126,781.72
5/11/78	299	183,343.05
6/23/78	199	145,251.98
8/ 3/78	155	98,972.69
10/23/78	1	180.48
	1,093	[2]$680,550.95

1979

Date	Head of Cattle Sold	Amount
3/26/79	219	$144,330.19
3/28/79	327	228,761.88
4/19/79	205	169,624.00
4/26/79	142	[1]104,519.00
5/14/79	2	1,526.25
	895	$648,761.32

1 Sales price less sales expenses.

2 Although the stipulation reflects a total in the amount of $680,550.95, the figures in this column total $680,551.04.

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During 1978 and 1979, petitioners sold cattle through the Farmers Livestock Commission Company in the respective amounts of $126,021 and $104,519, which were not reported on their income tax returns for those years. Also, on the returns for those years, petitioners understated their cost of cattle sold in the respective amounts of $86,504 and $590.

On January 3, 1978, petitioners sold 240 head of cattle for $126,021.12. In accordance with customary practice, within a few days after the January 3, 1978 sale, petitioners would have entered the sale in the Farm Book on the "Cattle Sales" page and the corresponding loan repayment to PCA on the "Loan Repayments" page. On line 1 of the "Cattle Sales" page for 1978 an entry was made for the "1-3" date, but the entry was erased prior to the preparation of petitioners' 1978 return. As a result of the erasure, the "Cattle Sales" page for 1978 contains no entry for the January 3, 1978 sale of 240 head of cattle. An entry was made on the "Loan Repayments" page for 1978 reflecting the loan repayment of $126,021.12 to PCA derived from the January 3, 1978, sale of 240 head of cattle.

Petitioners sold 142 head of cattle on April 26, 1979. The "Cattle Sales" page for 1979 in petitioners' Farm Book contains no entry for the sale of these cattle for which petitioners received a net amount of $104,519. The "Loan Repayments" page for 1979 in petitioners' Farm Book, however, reflects a loan repayment to PCA on April 26, 1979, in the amount of $111,118.78,

which is the amount derived from the sale of the 142 head of cattle for $104,518.78 and a water payment of $6,600.

Mr. Kness took petitioners' Farm Book to Howard Ray (Ray), a certified public accountant, and engaged him to prepare petitioners' 1978 and 1979 income tax returns. Ray provided no bookkeeping services and asked for no verification of the figures in the Farm Book. Ray picked up the yearend balances of the cattle sales column and the cost column and entered them in the appropriate blanks on the 1978 and 1979 income tax return forms. He did not review other portions of the Farm Book, such as the loan repayment account, to verify the accuracy of these balances.

Petitioners' 1979 income tax return was selected for audit as a random selection under the Internal Revenue Service Taxpayer Compliance Measurement program. Revenue Agent Jesse Rodriguez (Rodriguez) met with Mr. and Mrs. Kness on February 20, 1981, in the offices of Howard Ray and received some records. Rodriguez discovered from those records what appeared to be a substantial omission of 1979 income. He held a second meeting with Ray on July 6, 1981, and informed him that he had expanded the examination to cover 1978 and 1980. At this meeting Ray provided Rodriguez with a complete copy of petitioners' Farm Book. Petitioners did not attend the meeting.

On July 14, 1981, Rodriguez met with Mr. Kness at the Internal Revenue Service offices. He submitted to Rodriguez the original Farm Book and presented a stack of checks which, he stated, covered feed expenses for which petitioners had not

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received credit on their returns. Rodriguez observed that the amounts of four of the checks submitted by Mr. Kness had been altered as follows:

Check No.	Original Amount	Amount as Altered
323	$ 502.86	$ 1,502.86
195	$ 389.65	$ 1,389.65
1200	$5,975.85	$25,975.85
1196	$1,458.84	$14,058.84

The alterations of the amounts of the checks were crudely done and were obvious from a cursory examination of the checks. In addition, in the lower right-hand corner of each check is a magnetic ink printing which shows the amount for which the check cleared the bank.

Rodriguez called the alterations to Mr. Kness' attention, and Mr. Kness stated that he wanted to go home and talk to Mrs. Kness. Mr. Kness returned to Rodriguez' office later that day, stated that his wife had altered the checks, and offered to pay any proposed deficiency in order to get the matter settled.

A comparison of the "Loan Repayments" page provided to Rodriguez in early July 1981 with the original of the Farm Book disclosed that an entry on the Farm Book "Loan Repayments" page for January 3, 1978 had been erased sometime prior to Mr. Kness' presentation of the Farm Book on July 14, 1981. The erasure eliminated the record of the repayment of $126,021.12 made from the sale of 240 head of cattle on January 3, 1978.

Petitioners understated their taxable income on their joint returns for 1978 and 1979 in the respective amounts of $33,268

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and $108,619. As a result, they understated their income tax liabilities for those years in the respective amounts of $18,520 and $62,667.

In the notice of deficiency, respondent determined that petitioners are liable for the additions to tax set forth above.

OPINION

Section 6653(b)[2] provides for the imposition of an addition to tax if any part of any underpayment of tax is "due to fraud." Respondent has the burden of proving fraud by clear and convincing evidence. Sec. 7454(a); Rule 142(b), Tax Court Rules of Practice and Procedure. That burden is met if the evidence shows that the taxpayer attempted to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of such taxes. Stoltzfus v. United States, 398 F.2d 1002, 1004 (3d Cir. 1968); Webb v. Commissioner, 394 F.2d 366, 377 (5th Cir. 1968), affg. a Memorandum Opinion of this Court.

In our findings are set forth virtually undisputed facts which leave us no alternative but to conclude that at least part of petitioners' underpayments of tax for 1978 and 1979 were due

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2 SEC. 6653. FAILURE TO PAY TAX.

(b) Fraud.--If any part of any underpayment (as defined in subsection (c)) of tax required to be shown on a return is due to fraud, there shall be added to the tax an amount equal to 50 percent of the underpayment. In the case of income taxes and gift taxes, this amount shall be in lieu of any amount determined under subsection (a). In the case of a joint return under section 6013, this subsection shall not apply with respect to the tax of a spouse unless some part of the underpayment is due to the fraud of such spouse.

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to fraud. Petitioners' income tax returns were prepared from their Farm Book. Petitioners' bookkeeping method called for amounts received from the sale of cattle to be entered on two separate sheets of the Farm Book, the sheet for "Cattle Sales" and the sheet for "Loan Repayments." For both 1978 and 1979, cattle sales on a single date in each year in amounts in excess of $100,000 were entered on the "Loan Repayments" account but, when the Farm Book was turned over to the accountant for use in preparation of the returns, were not shown on the "Cattle Sales" account. The amount for 1978 was once entered in the "Cattle Sales" account but was erased before the Farm Book was made available to the accountant.

We are convinced that petitioners knew that the total annual amounts of the "Cattle Sales" as shown in the Farm Book would be used by their accountant in preparing their returns. They also knew that the accountant was not employed to audit the Farm Book. The inference is thus clear that petitioners attempted to evade the payment of taxes on the omitted sales by concealing the correct amount of the sales from their accountant and attempting to mislead him and, ultimately, the Internal Revenue Service as to the correct amounts of their income.

After submitting the misleading records to the accountant, petitioners compounded their falsifications by altering the 1978 "Loan Payments" account so that it would accord with their "Cattle Sales" account. They also presented to the revenue agent the clumsily altered checks to justify additional expense

deductions. Proof of such conduct supports a finding of fraud. McGee v. Commissioner, 519 F.2d 1121, 1126 (5th Cir. 1975), affg. 61 T.C. 249 (1973); Estate of Upshaw v. Commissioner, 416 F.2d 737, 741 (7th Cir. 1969), affg. a Memorandum Opinion of this Court.

Petitioners cite numerous court decisions in which fraud was proved by facts not shown in this case: Petitioners did not keep a double set of books; they did not destroy any of their records; they did not hide their assets or any other source of income; they did not refuse to cooperate with the Internal Revenue Service. Petitioners also list facts in this case which have been cited in other cases in which the courts have held that the proof was insufficient to establish fraud: Petitioners are elderly, in poor health, and have only a limited education; they employed a certified public accountant to prepare their returns; their single entry bookkeeping method left much room for error; some of the errors (failure to deduct certain costs) were unfavorable to petitioners; the revenue agent found fraud for only 2 years.

Although it is true that the facts in this case are not as complex as the facts in many fraud cases, they are clearly established. We have no credible exculpatory explanation of the gross income omissions for either year, for the erasures and falsifications of the 1978 records, or the clumsy attempts to falsify the amounts of expense checks submitted to the revenue agent to offset the omitted income. It is true that the erasures in the

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"Cattle Sales" account and the alterations of the checks were so clumsily done as almost to invite detection, but the intent in making the alterations and erasures is abundantly clear. The intent was to conceal and mislead.

We recognize that petitioners have worked very hard for many years in a business that requires hard work. We are also aware, as Mr. Kness emphasized at the trial, that they have operated their business with borrowed funds and have been victims of high interest rates and unstable cattle prices. Nonetheless, the facts are clear that there was an attempt to evade taxes by falsifying records. In such circumstances, section 6653(b) provides that an addition to tax "shall" be imposed. We have no alternative but to apply the law as written.

To reflect the foregoing,

Decision will be entered for the respondent.

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